A COMPARATIVE EVALUATION OF THE SOUTH AFRICAN INCOME TAX REGIME FOR INVESTMENTS USING TRUSTS

by
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SUMMARY

This study evaluates the South African income tax regime for investments using trusts. It considers whether reforms are required, and if so, how can this be done to create a tax framework that will encourage investment, limit tax avoidance and curb capital outflows, while considering South Africa's unique context and challenges.

In order to achieve the stated objective, the South African position is compared to that of the United Kingdom ("UK") and Belgium. The UK was selected since it is the origin of the trust concept as it is known today and the addition of Belgium, which is a civil law country, adds a unique perspective to the discussion. The dissertation commences with an overview of the essential aspects of trusts in each of the jurisdictions. This discussion formed the foundation of the chapters to follow. The key similarities and differences of the law of trusts in the comparative jurisdictions are identified and discussed. The dissertation then introduced and unpacked the notion of a "tax haven". This was achieved by thoroughly analysing the core aspects and most crucial questions regarding tax havens. The tax haven topic was approached by considering the technical terminology and examining how tax havens come to exist and what role they play in the global economy. Mauritius was used as a functional jurisdiction to illustrate some of these concepts in practice. This was a natural choice since Mauritius is geographically comparable and has experienced great economic success in recent years. The author also identified a subset or deviation of the traditional tax haven, which was termed quasi tax havens.

With the aforesaid as background, the dissertation shifted the focus to the general income tax treatment of trusts. This chapter examined the different policy positions and the tax rules applicable to trusts. The different approaches and practical effects thereof were discussed and formed the basis for subsequent recommendations.

Finally, the dissertation turned to an in-depth discussion of the various special anti-avoidance rules that can apply to trusts. This chapter concluded with a comparison of the positions adopted in the three jurisdictions and identified the possible strengths and weaknesses of the special anti-avoidance rules in the comparative jurisdictions.

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These shortcomings were used to formulate possible recommendations for South Africa.

The study found that it is evident that trusts are very useful institutions, and it is regrettable that such negative perceptions of trusts have been created. Notwithstanding, the unique nature of South African trusts allows unmatched flexibility and adaptability. If trusts are used correctly, they can address a range of circumstances and be a preferred investment vehicle. However, to enhance the use of trusts, it is paramount that the tax framework is supportive.

Although the possibility exists for trusts to be misused, the author has proposed a new tier-based tax framework for trusts. This proposal aims to change the negative narrative on trusts and introduce a new compact between taxpayers and revenue authorities. Ultimately, the balance is between an investment-friendly regime and a responsible jurisdiction.

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OPSOMMING

Hierdie studie evalueer die Suid-Afrikaanse inkomstebelasting stelsel vir beleggings deur trusts. Die studie oorweeg of verbeterings benodig word en, indien wel, hoe dit gedoen kan word om 'n belastingstelraamwerk daar te stel wat beleggings sal aanmoedig, belasting vermyding sal beperk en kapitale uitvloei sal verminder, terwyl Suid-Afrika se unike konteks en uitdagings in ag geneem word.

Ten einde die genoemde doel te bereik, is die Suid-Afrikaanse posisie vergelyk met dié in die Verenigde Koningkryk ("VK") en België. Die VK is gekies omdat daardie land die oorsprong is van die trustkonsep soos dit vandag verstaan word. België, wat 'n siviele regstelsel het, is bygevoeg weens die unieke perspektief wat hierdie land toevoeg tot die bespreking. Die tesis begin met 'n oorsig oor die wesensaspekte van trusts in elk van die jurisdiksies. Dié bespreking vorm die fondasie van die daaropvolgende hoofstukke. Die belangrikste ooreenkomste en verskille tussen die trustreg van die vergelykende jurisdiksies is geïdentifiseer en bespreek. Daarna het die tesis die begrip "belasting toevlug" ("tax haven") bekend gestel en bespreek deur die kernaspekte en belangrikste vrae rondom belasting toevlugte behoorlik te analiseer. Die onderwerp van belasting toevlugte is benader deur die tegniese terminologie te oorweeg en deur te ondersoek hoe belasting toevlugte tot stand kom en die rol wat hulle speel in die globale ekonomie. Mauritius is gebruik as 'n funksionele jurisdiksie om sommige van die konsepte in die praktyk te illustreer. Mauritius was 'n natuurlike keuse aangesien Mauritius geografies vergelykbaar is en die afgelope paar jaar groot ekonomiese suksesse behaal het. Die outeur het ook 'n onderafdeling of afwyking van die tradisionele belasting toevlug geïdentifiseer, wat "quasi tax havens" genoem is.

Met die voorafgaande as agtergrond, het die tesis se fokus verskuif na die algemene inkomstebelasting hantering van trusts. Hierdie hoofstuk het die verskillende beleidsposisies en die belastingreëls ten opsigte van trusts ondersoek. Die verskillende benaderings en die praktiese uitwerking daarvan is bespreek en het die basis gevorm van die latere aanbevelings.

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In die laaste instansie het die tesis ‘n diepgaande bespreking bevat van die verskillende spesiale teenvermydingsreëls wat op trusts van toepassing mag wees. Hierdie hoofstuk is afgesluit met ‘n vergelyking van die posisies wat die drie verskillende jurisdiksies aanvaar het en het die moontlike sterk- en swakpunte in elk van hierdie jurisdiksies uitgewys. Die tekortkominge is gebruik om moontlike aanbevelings vir Suid-Afrika te formuleer.

Die tesis het bevind dat trusts duidelik baie nuttige instellings is en dat die negatiewe persepsies wat teenoor trusts ontstaan het, betreurenswaardig is. Nieteenstaande leen die unieke aard van die Suid-Afrikaanse trust hom tot ongeëwenaarde buigsaamheid en aanpasbaarheid. Indien trusts korrek gebruik word, kan hulle ‘n wye reeks van situasies aanspreek en as ‘n voorkeur beleggingsinstrument gebruik word. Maar om die gebruik van trusts aan te moedig, is dit van kardinale belang dat die belastingraamwerk die gebruik ondersteun.

Alhoewel die moontlikheid bestaan dat trusts misbruik kan word, het die outeur ‘n nuwe belastingraamwerk vir trusts voorgestel wat gebasseer is op verskillende vlakke. Hierdie voorstel poog om die negatiewe storie oor trusts te verander en ‘n nuwe verdrag tussen belastingbetalers en belastingowerhede in te stel. Uiteindelik moet ‘n balans gevind word tussen ‘n beleggingsvriendelike stelsel en ‘n verantwoordelike jurisdiksie.

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"No one who achieves success does so without acknowledging the help of others. The wise and confident acknowledge this help with gratitude" – Alfred North Whitehead

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ABBREVIATIONS

AG	Advocate General
AI	Artificial intelligence
ATAF	African Tax Administration Forum
BEPS	Base erosion and profit shifting
BITC	Belgian Income Tax Code 1992
CFC	Controlled Foreign Corporation
CGT	Capital gains tax
CMAC	Centrally managed and controlled
COEI	Centre of economic interests
CRS	Common reporting standard
DTA	Double tax agreements
DTC	Davis Tax Committee
EC	European Commission
ECJ	European Court of Justice
EEA	European Economic Area
EIUR	Exchange of information upon request
EU	European Union
FATCA	Foreign Account Tax Compliance Act
FDI	Foreign direct investment
FSF	Financial stability form
FSI	Financial Secrecy Index
GAAR	General anti-avoidance rule
GBL	Global Business License
GDP	Gross domestic product
GEDB	Global ease of doing business
GFA	General Fiscal Administration
GFT	Global Forum on Taxation
GSW	Global scale weight
HMRC	Her Majesty's Revenue and Customs
HPTR	Harmful preferential tax regimes
IGA	Inter-governmental agreements
IIAG	Ibrahim Index of African Governance

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IMF	International Monetary Fund
IPLA	International Private Law Act of 16 July 2004
ITA	Income Tax Act 58 of 1962
NCA	National Credit Act
OECD	Organisation for Economic Growth, Co-operation and Development
OFC	Offshore financial centre
POEM	Place of effective management
SAAR	Specific anti-avoidance rules
SADC	Southern African Development Community
SARS	South African Revenue Service
SRT	Statutory residence test
TFEU	Treaty on the Functioning of the European Union
TICPI	Transparency international's corruption perception index
TIEA	Tax information exchange agreements
TJN	Tax Justice Network
TPCA	Trust Property Control Act 57 of 1988
UK	United Kingdom
UN	United Nations
VAT	Value-added tax
WGI	World governance index

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CHAPTER 1: A COMPARATIVE EVALUATION OF THE SOUTH AFRICAN INCOME TAX REGIME FOR INVESTMENTS USING TRUSTS

1 1 Introduction

South Africa is experiencing severe economic, political, and social challenges. The high levels of capital outflows and tax avoidance exacerbate this. The reduced tax revenue and limited investments in the country[1] greatly impair the state's ability to address these problems. Possibly embarking on tax reforms that will not just strengthen anti-avoidance mechanisms but also advance South Africa's attractiveness for investments using trusts can aid in resolving some of these challenges.

1 1 2 Background to the South African economy

The South African economy is regarded as the most advanced on the continent.[2] Based on the gross domestic product ("GDP"), South Africa is the second largest economy in Africa, behind Nigeria.[3] In recent years, South Africa was dethroned by the island nation of Mauritius in terms of per capita income. Mauritius is also quickly becoming the preferred investment destination in Africa, a position previously associated with South Africa.[4] Over the last decade, South Africa has experienced a number of problems that had detrimental effects on the country. These issues were further amplified and exacerbated by the COVID-19 pandemic, which almost brought the economy and society to its knees[5]. First, the unemployment rate in South Africa averaged 26,74% from 2000 until 2022, reaching an all-time high of 35,30% in the fourth quarter of 2021. The record low of 21,50% was in the fourth quarter of 2008.[6]

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[1] Unless the context clearly indicates otherwise, for purposes of this study "investments" refer to both inbound and outbound investments. It also includes all types of investments, such as portfolio investments and capital investments.

[2] AFRASIA "AFRASIA South Africa Wealth Report 2021" (20-04-2021) *ISUU* <https://issuu.com/newworldwealth/docs/africa_2021?utm_medium=referral&utm_source=www.afrasiabank.com> (accessed 20-12-2022).

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These numbers are among the highest in the world.[7] If the wider definition of unemployment is used, including despondent job seekers, the number for 2022 rises to 44,1%.[8] This has resulted in a death spiral that continuously repeats itself. Unemployment exacerbates the poverty dilemma, which means fewer consumers have income to spend, which causes the economy to stagnate. The stagnation of economic growth, in turn, leads to more job losses. This is evident with the economic growth, on average barely exceeding 1,6% per annum.[9] The GDP growth for 2023 is projected to be 1.4% at the last medium-term budget ("MTB") at the end of 2022.[10] The International Monetary Fund ("IMF") expects South Africa's economy to grow at 1,1% in 2023.[11] This is in contrast with the world economic growth, which is projected to be 3,2% in 2023.[12]

With the South African population growth averaging approximately 1,6% annually,[13] the effect is that the per capita income is diminishing. South Africa needs to achieve real GDP growth of at least 5% to start making inroads in the unemployment and poverty dilemma.[14] Adding to the woes is the troublesome state of the education system. These problems are widespread and range from teachers absent from school[15] and teachers that are inadequately trained[16] to a lack of proper

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[13] The World Bank Data "Population growth (annual%) – South Africa" (2022) *The World Bank* <https://data.worldbank.org/indicator/SP.POP.GROW?locations=ZA> (accessed 20-12-2022).

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infrastructure.[17] This results in learners without basic literacy skills,[18] dismal science and mathematics competency,[19] and, overall, an education system that cannot adequately address the skills shortages.[20] Exacerbating the problem is the high outflows of professional and skilled individuals.[21] This coincides with large amounts of wealth leaving the country[22] and further contributes to the rut South Africa finds itself in. As a result of the aforementioned factors, South Africa is burdened with a high chronic poverty level. Statistics South Africa defines the poverty band as income ranging between less than R624 and R1 335 per person per month.[23] Based on this measurement, more than 55,5% of South Africans live in poverty.[24]

Furthermore, South Africa is the unfortunate recipient of the title "the most unequal country in the world".[25] The wide income discrepancies further exacerbate the socio-economic problems in the country. It also does not help that the government was unable to make any meaningful change in most people's lives over the last 25 years. In addition, these problems play out against the backdrop of low consumer and

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[17] B Phakathi "School infrastructure is still largely inadequate" (08-04-2019) *Business Live* <https://www.businesslive.co.za/bd/national/2019-04-08-school-infrastructure-is-still-largely-inadequate/> (accessed 30-05-2022).

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[21] K Khumalo "South African brain drain – shocking number of skilled professionals leaving the country" (21-05-2019) *My Broadband* <https://mybroadband.co.za/news/business/306950-south-african-brain-drain-shocking-number-of-skilled-professionals-leaving-the-country.html> (accessed 31-05-2022).

[22] BusinessTech "New data shows that rich South Africans are leaving the country" (26-02-2019) *BusinessTech* <https://businesstech.co.za/news/banking/301878/new-data-shows-that-rich-south-african-are-leaving-the-country/> (accessed 31-05-2022).

[23] Stats SA "National Poverty Lines 2022" (2022) *StatsSA* <https://www.statssa.gov.za/publications/P03101/P031012021.pdf> (accessed 20-12-2022).

[24] Poverty and Equity Brief "South Africa" (2020) *The World Bank* <https://databankfiles.worldbank.org/data/download/poverty/33EF03BB-9722-4AE2-ABC7-AA2972D68AFE/Global_POVEQ_ZAF.pdf> (accessed 20-12-2022).

[25] World Bank "New World Bank report assesses sources of inequality in five countries in Southern Africa" (09-03-2022) *WorldBank* <https://www.worldbank.org/en/news/press-release/2022/03/09/new-world-bank-report-assesses-sources-of-inequality-in-five-countries-in-southern-africa> (accessed 20-12-2022).

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business confidence,[26] structural constraints,[27] policy uncertainty,[28] an inefficient public sector,[29] struggling state-owned enterprises ("SOEs"),[30] high crime rates,[31] and various social issues.

1 1 3 The role of taxation

According to the Davis Tax Committee ("DTC"), the tax system's and the state's roles are intertwined.[32] Depending on one's political ideology, taxation can be regarded as the "extractive exercise of predatory state power" or as an important mechanism for redistribution, social solidarity and justice", with various extreme views on either side.[33] According to the African Tax Administration Forum ("ATAF"), the role of taxation in developing countries goes beyond just the fiscal component.[34] It plays a far bigger substantive role as well. Therefore, tax policy is shaped and influenced by economic and political institutions, interest groups and political culture.[35] Tax could therefore be used as an instrument to address some of the challenges that a developing country, such as South Africa, faces.

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[26] Trading Economics "South African consumer confidence" (2022) *Trading Economics* <https://tradingeconomics.com/south-africa/consumer-confidence> (accessed 20-12-2022).
Trading Economics "South African business confidence" (2022) *Trading Economics* <https://tradingeconomics.com/south-africa/business-confidence> (accessed 20-12-2022).

[27] J Fedderke "South African growth: Context, cause and consequence" (2018) 82 *TJHSF* 6.

[28] A Slabbert "Policy uncertainty key deterrent to SA's investment, growth" (23-01-2019) *MoneyWeb* <https://www.moneyweb.co.za/news/south-africa/policy-uncertainty-key-deterrent-to-sas-investment-growth/> (accessed 01-06-2022).

[29] D Fourie & W Poggenpoel "Public sector inefficiencies: are we addressing the root cause?" (2016) 31 *SAJAR* 3.

[30] A Mayeda "Rand held by political uncertainty, says IMF" (12-04-2019) *Fin24* <https://www.fin24.com/Markets/Currencies/rand-held-back-by-political-uncertainty-says-imf-20190412> (accessed 01-06-2022).

[31] G Mahofa, A Sundaram & L Edwards "Impact of crime on firm entry: evidence from South Africa" *ERSA Working Paper* 652 <https://econrsa.org/wp-content/uploads/2022/06/working_paper_652.pdf> (accessed 14-12-2022).

[32] The Davis Tax Committee "Macro analysis of the tax system and inclusive growth in South Africa" (April 2016) *DTC* <https://www.taxcom.org.za/docs/20160421%20DTC%20Macro%20Analysis%20Final%20Report%20-%20Full%20Report.pdf> (accessed 14-12-2022).

[33] The Davis Tax Committee "Macro analysis of the tax system" (April 2016) *DTC* 8.

[34] African Tax Administration Forum "Cross border taxation: Implications for Africa" (December 2014) *ATAF* <https://events.ataftax.org/index.php?page=documents&func=view&document_id=90> (accessed 14-12-2022).

[35] The Davis Tax Committee "Macro analysis of the tax system" (April 2016) *DTC* 8.

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1 1 4 Tax avoidance, capital outflows and foreign direct investment

Developing countries are the most significantly affected by tax avoidance or tax evasion practices.[36] The lack of appropriate legislation, a culture of non-compliance, limited tax reporting and low-tax education are partially to blame.[37] One possible reason for the disproportional burden on developing countries can be attributed to the large dependence on tax revenue and the low tax base.[38] Additional factors include the lack of resources, capacity, systems and expertise at the tax authorities to adequately prevent and detect such practices.[39] Contributing to the problem is the lack of political will to act decisively.[40] The reduced tax revenue leads to a large budget deficit. The result of this is that there is not enough funding for the developmental projects or for crucial service delivery expansion that is required to grow the economy and eventually improve the lives of ordinary people.[41] For this reason, there is a direct correlation between minimising aggressive tax avoidance, improving collection efficiency and the country's welfare.[42]

One possible solution that can contribute to addressing some of these problems is curbing capital outflows and tax avoidance. It is estimated that South Africa is a net exporter of capital.[43] This means that more capital leaves the country than enters it. A distinction should be drawn between legitimate capital flight and illicit capital flight.[44]

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[36] A Cobham "Tax evasion, tax avoidance and development finance" (2005) *Working Paper* 129 <https://www.taxjustice.net/cms/upload/pdf/qehwps129-revised.pdf> (accessed 14-12-2022).
[37] AW Oguttu "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *Working Paper* 54 <https://opendocs.ids.ac.uk/opendocs/bitstream/handle/123456789/12802/ICTD_WP54.pdf> (accessed 13-06-2022).
[38] Oxfam International "Drug companies as tax dodgers, price gougers, and influence peddlers" (17-09-2018) *Oxfam* <https://www.oxfam.org/en/research/prescription-poverty> (accessed 01-06-2022).
[39] OECD "Supporting the development of more effective tax systems" (2011) *OECD* <https://www.oecd.org/ctp/48993634.pdf> (accessed 01-06-2022).
[40] Oguttu "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *Working Paper* 54.
[41] World Finance "The true costs of tax avoidance" (20-01-2015) *World Finance* <https://www.worldfinance.com/strategy/the-true-costs-of-tax-avoidance> (accessed 01-06-2022).
[42] For a distinction between tax avoidance and aggressive tax avoidance see Kessler *Taxation of Non-Residents and Foreign Domiciliaries* Chapter 2 and 38.
[43] Trading Economics "South Africa – Foreign direct investment, net outflows (% of GDP)" (2022) *Trading Economics* <https://tradingeconomics.com/south-africa/foreign-direct-investment-net-outflows-percent-of-gdp-wb-data.html> (accessed 01-06-2022).
[44] Oguttu "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *Working Paper* 54.

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The latter is said to be this century's biggest pernicious global development.[45] Over the last few years, billions of rands have left the country.[46] Besides the legitimate capital flows, the extent of illicit flows is difficult or near impossible to pinpoint. The Global Financial Integrity report estimates the loss in tax revenue to be billions of rands, with total capital flight around the one trillion mark.[47] This translates to over 7,6% of the South African economy.[48] Closely related is the revenue lost by trade mis-invoicing.[49] It is not just illegal measures that adversely affect developing countries. Legitimate capital flows and tax avoidance are strictly speaking legal, but it does not mean the consequences are any less severe.

One example of such conduct, which poses a serious challenge to developing countries, is the so-called base erosion and profit shifting ("BEPS"). The Organisation for Economic Growth, Co-operation and Development ("OECD") defines BEPS as "tax planning strategies that exploit gaps in the architecture of the international tax system to artificially shift profits to places where there is little or no economic activity or taxation".[50] Due to the nature of developing countries, BEPS manifests and impacts differently in developing countries compared to the developed world.[51] This gave rise to the legitimacy of the BEPS action plan being questioned.[52] This is due to developing countries' limited participation in the decision making regarding the BEPS framework. There are concerns that the mismatch between the priorities of developing countries and that of the OECD may lead to key areas not being adequately addressed.[53] Furthermore, the perceptions and views towards taxation of developing countries differ from that of their developed counterparts.[54] The ATAF, therefore, held that developing

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[45] Oguttu "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *Working Paper* 54.
[46] M Schüssler "Tragic data shows capital fleeing along with jobs" (16-01-2019) *Moneyweb* <https://www.moneyweb.co.za/moneyweb-opinion/soapbox/tragic-data-shows-capital-fleeing-along-with-jobs/> (accessed 01-06-2022).
[47] Global Financial Integrity Report *Illicit Financial Flows to and from 148 Developing Countries: 2006-2015* (2019).
[48] 47.
[49] Global Financial Integrity Report *South Africa: Potential revenue losses associated with trace misinvoicing* (2018).
[50] OECD "BEPS 2015 Financial Reports" (2015) <https://www.oecd.org/tax/beps-2015-final-reports.htm> (accessed 13-06-2022).
[51] Oguttu "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *Working Paper* 54.
[52] I Burgers "Corporate taxation and BEPS: A fair slice for developing countries" (2017) 10 *ELR* 29.
[53] 31.
[54] 32.

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countries must come up with innovative ideas to solve the unique problems faced by developing countries.[55] In addition, due to the limitations and challenges faced by revenue authorities in developing countries, the practicality of implementing BEPS is unclear.[56] According to the OECD, capacity building is a paramount prerequisite for developing countries to implement and apply the BEPS action plan successfully.[57] To this extent, organisations such as the OECD, IMF and G20 have launched various initiatives to help prepare and upscale capacity at revenue authorities in developing countries. It is crucial to remember that even though these problems share a common result, the actions and methods required to prevent or curb such conduct differ significantly.

Closely related to solving these challenges is attracting more foreign direct investment ("FDI") to South Africa.[58] Over recent years, South Africa only managed to attract FDI equivalent to 1,2% of GDP.[59] This is in contrast to the world average of 5%.[60] The importance of the former was emphasised with the renewed investment drive that the president embarked on over the last few years.[61] This may prove difficult if one considers the continuation of the downward trajectory of FDI that entered developing countries over the last decade.[62] If South Africa can keep more domestic capital within the country and lure new investment, it may serve as a stimulus to

[55] African Tax Administration Forum *Cross border taxation* 16.

[56] Oguttu "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *Working Paper* 54.

[57] OECD "Part 1 of a report to G20 development working group on the impact of BEPS in low income countries" (2014) *OECD* <http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf> (accessed 20-06-2022).

[58] T Masipa "The relationship between foreign direct investment and economic growth in South Africa: Vector error correction analysis" (2018) 18 *AC* 1-8.

[59] PricewaterhouseCoopers "What foreign investors want South African insights from a global perspective on factors influencing FDI inflows since 2010" (2010) <https://www.pwc.co.za/en/assets/pdf/strategyand-what-foreign-investors-want.pdf> (accessed 17-06-2022).

[60] PricewaterhouseCoopers "What foreign investors want South African insights from a global perspective on factors influencing FDI inflows since 2010" (2010) *PwC*.

[61] D Faku "Billions secured for South African investment at conference" (28-10-2018) *IOL* <https://www.iol.co.za/business-report/economy/billions-secured-for-south-african-investment-at-conference-17658145> (accessed 01-06-2022); South African Government "President Cyril Ramaphosa: 4th South Africa Investment Conference" (24-03-2022) *South African Government* <https://www.gov.za/speeches/president-cyril-ramaphosa-4th-south-africa-investment-conference-24-mar-2022-0000> (accessed 21-12-2022).

[62] United Nations Conference on Trade and Development "World Investment Report 2018" (2018) *UNCTAD* <https://unctad.org/en/PublicationsLibrary/wir2018_en.pdf> (accessed 02-06-2022).

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kickstart economic growth. This, in turn, could aid in reducing social problems and put South Africa on a trajectory towards more inclusivity and prosperity.

1 1 5 Importance of tax policies

One mechanism that can be used to achieve this is to ensure that the correct tax policies are in place. Tax policies can either help prevent unwanted behaviour such as tax avoidance and tax evasion or facilitate these behaviours.[63] The same is true for attracting investments. Therefore, tax policy reforms should not be undertaken lightly and must draw from international experience and best practices to ensure the intended objectives are met.[64]

In designing a tax policy framework, it is crucial to keep the following criteria in mind against which to evaluate it: efficiency, equity and administrability.[65] Furthermore, it is critical to remember the primary objectives of taxation, namely raising revenue for the state, wealth redistribution and regulating behaviour.[66] The formulation of tax policies is, therefore, a fine balancing act. The challenging task is to find the optimum proportion between the three objectives. The first objective enjoys widespread consensus and is arguably the most important. This is simply because the tax revenue is the lifeline of the state. However, the redistributive aim of taxation is far more controversial,[67] even though the majority of countries incorporate this function in their tax system to varying degrees.

Conversely, there are organisations such as Oxfam that are of the opinion that it is not used enough.[68] In terms of South Africa, the DTC found that the redistributive role of taxation is rather limited.[69] Other measures, such as increased social spending, can better achieve this goal.[70] The position for the last goal is similar to the aforementioned. Some authors argue taxation should not be used to shape behaviour.

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[63] C Fuest & N Riedel *Tax Evasion and Tax Avoidance in Developing Countries: The Role of International Profit Shifting* (2010) 8.
[64] 10.
[65] R Avi-Yonah "The three goals of taxation" (2005) *SSRN Electronic Journal* 3 <https://ssrn.com/abstract=796776 or http://dx.doi.org/10.2139/ssrn.796776> (accessed 02-06-2022).
[66] Avi-Yonah "The Three Goals of Taxation" (2005) *SSRN Electronic Journal* 20.
[67] Avi-Yonah "The Three Goals of Taxation" (2005) *SSRN Electronic Journal* 3.
[68] D Itriago "Owning Development: Taxation to fight poverty" (2011) *Oxfam* <https://www-cdn.oxfam.org/s3fs-public/file_attachments/rr-owning-development-domestic-resources-tax-260911-en_3.pdf> (accessed 02-06-2022).
[69] The Davis Tax Committee "Macro analysis of the tax system" (April 2016) *DTC* 57.
[70] The Davis Tax Committee "Macro analysis of the tax system" (April 2016) *DTC* 57.

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The converse is also true; there are strong views in favour of rewarding so-called positive behaviour and discouraging so-called negative behaviour by using monetary incentives. This phenomenon is known as tax nudging.[71] The concept of nudging is not a new invention. Nudging has been used successfully in various fields for the last several decades. The practice is fairly new to the realm of taxation. This additional facet of tax policy has proved to be quite successful. The most positive results have been observed in increasing saving and investment rates. This is closely followed by preventative behaviour, especially in the health and environment sectors.[72]

1 1 6 Taxation as an investment factor

It is well known that taxation is one of the factors that may influence an investor's decision to invest. It is not the sole or necessarily the determining factor, but it is nonetheless substantially relevant.[73] It is interesting to note that the consideration is not limited to income tax. It has been held that indirect taxes can have an equally negative influence on FDI.[74] It should be observed that for tax reforms to be truly successful, these reforms must coincide with creating an investor-friendly climate.[75] To this extent, many countries are embarking on widespread regulatory and legislative reforms.[76] Those countries that have not yet started the process are encouraged to do so or risk being left behind. Recent studies indicate the rising importance of tax considerations in investment locations.[77] This compared with the 1900s when taxation played a far less decisive role in investment decisions.[78] This can possibly be attributed to the increased tax competition among countries. Furthermore, it is a direct

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[71] H Gribnau & K Boor "Legal aspects of behaviourally informed strategies to enhance tax compliance" (2018) *SSRN Electronic Journal* 210 <https://www.ssrn.com/abstract=3295964> (accessed 02-06-2022).
[72] Gribnau & Boor "Legal aspects of behaviourally informed strategies to enhance tax compliance" (2018) *SSRN Electronic Journal*.
[73] AJ Coelho "The influence of the tax burden in attracting foreign direct investment" (2010) *Mestranol em Economia* Ano Lectivo 2009/2010.
[74] MA Desai & JR Hines Jr "Foreign direct investment in a world of multiple taxes" (2001) 88 *JPE* 2727-2744.
[75] Fuest & Riedel *Tax Evasion and Tax Avoidance in Developing Countries* 10.
[76] United Nations Conference on Trade and Development "World Investment Report 2018" (2018) *UNCTAD.*
[77] Organization for Economic Co-operation and Development "Tax effects on foreign direct investment" (2022) *OECD* <https://www.oecd.org/investment/investment-policy/40152903.pdf> (accessed 02-06-2022).
[78] Coelho (2010) *Mestrado em Economia* Ano Lectivo 2009/2010.

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consequence of more mobile capital. In addition, the quality of infrastructure is also a significant factor.[79] For corporate investors, other noteworthy factors include the market size, cost of labour, safety, political stability, economic freedom and policy certainty.[80] In addition to the above, individual investors place a high premium on asset protection and modern legislation.[81]

1 1 7 The trust as an investment entity

A widely used entity for investment purposes is the trust. The popularity of the trust can be attributed to the flexibility and versatility that it offers.[82] Both individuals and corporations make extensive use of trusts.[83] The trust entity is particularly attractive for the capital protection and profit maximisation it allows.[84] Already in the late nineties, it was estimated that trusts hold up to 25% of the world's wealth.[85] With the subsequent rise in the popularity of secret jurisdictions, very little updated data is available. It is, however, very likely that current figures are within a similar range or even higher. This may be due to the paramount role that trusts play in tax haven jurisdictions. It is important to remember that the nature of tax haven jurisdictions makes estimating their wealth difficult.[86] It has been held that the role of trusts in the financial system is severely underestimated.[87] Even in South Africa, the trust is widely used. However, the attractiveness of trusts in South Africa has been somewhat diminished by legislation that treats trusts rather unfavourably. Regardless of this fact, it is still estimated that there are over 330 000 registered trusts in South Africa.[88] Throughout

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[79] C Bellak & M Leibrecht "Improving infrastructure or lowering taxes to attract foreign direct investment" (2010) 6 *VCCSII* 1-3.

[80] PricewaterhouseCoopers "What foreign investors want South African insights from a global perspective on factors influencing FDI inflows since 2010" (2010) *PwC*.

[81] PricewaterhouseCoopers "What foreign investors want South African insights from a global perspective on factors influencing FDI inflows since 2010" (2010) *PwC*.

[82] MJ de Waal "Trust and fiduciary mechanisms" in R Blanpain (ed) *International Encyclopaedia of Laws* (2015).

[83] B Harrington "Trusts and financialization" (2017) 15 *S-ER* 32.

[84] 32.

[85] J Ware & PEW Roper "The world of offshore sham trusts" (1998) 13 *Insurance and Tax* para 1.

[86] A Alstadsaeter, N Johannsen & G Zucman "Who owns the wealth in tax havens? Macro evidence and implications for global inequality" *NBER Working Paper* 23805.

[87] J Riches "Are transparency and the resignation of trusts necessary?" (2013) 19 *T&T* 344.

[88] The Davis Tax Committee "Estate Duty" (28-04-2016) *TaxCom* <http://www.taxcom.org.za/docs/20160428%20DTC%20Final%20Report%20on%20Estate%20Duty%20-%20website.pdf> (accessed 10-03-2022).

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the commonwealth, the trust remains a popular choice among investors. This does not even mention the prominence of trusts in the various island nations that repositioned themselves as attractive investment destinations. This trend has even spread to traditional civil law countries. Even though they do not have their own domestic trusts, they had to enact legislation governing the taxation of trusts. In the latter case, residents tend to use foreign trusts to invest in other jurisdictions. For example, Belgium enacted the Cayman tax regime for exactly this purpose.[89] The Cayman tax system incorporates widespread attribution rules, where the income of foreign trusts is deemed to be that of the founder unless specific exclusions apply.[90] What makes the Cayman tax provisions unique is the depth it can go to. Even income that is generated two or three structures down from the trust can potentially be attributed to the founder.[91]

It should also be observed that there is an increasingly negative perception surrounding the use of trusts. One likely reason is the wide adoption of trusts or the media publicity of the use of trusts by prominent leaders. In some circles, trusts have become synonymous with tax avoidance and facilitating the illicit flow of capital.[92] This perception may be completely misplaced, seeing that a very small percentage of trusts are used for such devious activities.[93] Any framework for the taxation of trusts should have proper safeguards in place against the misuse of the trust structure while promoting its benefits.

1 2 Premise and objective

If the South African tax framework can be changed to prevent the rapid outflow of capital while simultaneously creating a conducive environment for investment to flourish, the country will be able to greatly strengthen its tax base, secure economic growth and start to address the socio-economic issues. This will generate the necessary revenue to deliver on all the country's obligations. This must, however, be

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[89] J Draye & A Nijs "The Cayman tax game: a changer for the Belgian income tax treatment of trusts?" (2016) 22 *T&T* 510.
[90] GD Goyvaerts "The changes introduced by the Belgian look-through taxation regulations or Cayman Tax 2.0" (2019) 25 *T&T* 205.
[91] 205.
[92] A Knobel "Trusts: Weapons of mass destruction" (2017) *Tax Justice Network* <http://www.taxjustice.net/wp-content/uploads/2017/02/Trusts-Weapons-of-Mass-Injustice-Final-12-FEB-2017.pdf> (accessed 11-03-2022).
[93] J Riches "Are transparency and the resignation of trusts necessary?" (2013) 19 *T&T* 345.

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achieved without compromising international standards and still conforming with the best guidelines to reduce harmful tax practices.

This dissertation investigates whether the South African income tax regime on trusts should be reformed, considering South Africa's unique context and challenges. The goal is not only to identify and address the shortcomings (if any) in the current income tax system but also to suggest a framework that will encourage investment, strengthen anti-avoidance measures, and reduce capital outflows to help resolve some of the issues South Africa faces. The lessons learnt and different perspectives from other jurisdictions will inform certain of these suggestions.

The study evaluates the South African income tax regime for trusts; however, capital gains tax is excluded from the ambit of the study. Therefore, both inbound and outbound investments are considered, and various combinations of residency of the founder, trust and beneficiaries are addressed. This will ensure an accurate overview of the current system and allow for relevant and targeted suggestions to be made where it is appropriate.

1 3 Research question

The research question can therefore be formulated as follows:
Should the South African income tax regime in respect of trusts be reformed? If so, how can this be done to create a tax framework that will encourage investment, limit tax avoidance and curb capital outflows while considering South Africa's unique context and challenges?

1 4 Limitations

The dissertation focuses exclusively on investments made through trusts. Therefore, no other types of legal entities or ownership structures are considered. This exclusion also extends to controlled foreign companies ("CFCs"). The research is further limited to income tax only. For this reason, this dissertation does not address other taxes such as capital gains tax ("CGT"), value-added tax ("VAT"), donations tax, stamp duty, transfer duty, estate duty or inheritance tax.

For the discussion on income tax, the focus of the dissertation is on the aspects relevant to trusts. The more general concepts or themes are merely mentioned. Where

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appropriate, an overview of the topic is provided to lay the foundation for the discussions that follow and for completeness's sake.

Notwithstanding the range of tools available in a country's arsenal against the scour of tax avoidance, such as exchange of information arrangements and specific anti-avoidance rules ("SAAR"), there remains a real possibility that taxpayers will devise a way to fall outside the letter of the law, and thereby circumvent the objectives of such measures. Therefore, it is advisable to have an additional layer of protection in place. This will typically take the form of a general anti-avoidance rule ("GAAR"). It is designed to be much wider in scope than specific or targeted anti-avoidance provisions. This wide ambit enables a GAAR to prevent a tax avoidance arrangement, even if it complies with the letter of the law, which makes it an invaluable tool. This view is echoed by the OECD, which sees it as one of the crucial pillars against tax avoidance.[94]

Even though it is permissible in most countries to order one's affairs in such a way as to minimise one's tax burden, it is necessary to strike a balance.[95] A GAAR can potentially be useful to curb transactions involving trusts, which is aimed at tax avoidance with no or little substantive value and where specific provisions fall short. Furthermore, it can also protect against ambiguity and inconsistencies in legislation.

Because GAARs are designed to be general, GAARs can apply to all entity types and manner of situations. Thus, GAARs are not aimed at trusts specifically. But this does not mean that GAARs are not relevant to trusts. On the contrary, the possible application of the GAAR should always be considered where a trust is used for tax planning purposes. But SAARs will usually be applied before GAARs; hence, for this dissertation, the discussion of the SAARs is of more value.

Since the dissertation focuses on trusts, it makes sense that the discussion of provisions specifically aimed at trusts is prioritised. In light of the aforesaid considerations, the discussion of the GAARs is limited to an overview.

Before elaborating on the demarcation of the types of taxes discussed in the dissertation, it should be stressed that the decision to exclude CGT from the ambit of

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94 Å Johansson "Anti-avoidance rules against international tax planning: a classification" (2016) *OECD* <https://www.oecd.org/eco/Anti-avoidance-rules-against-international-tax-planning-A-classification.pdf> (accessed 07-06-2022).

95 JD Rolim "The general anti-avoidance ruleits expanding role in international taxation" (2016) 44 *Intertax* 817.

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the dissertation was not taken lightly. In the planning phase of this dissertation, CGT was very much part of the analysis. However, despite the very close relationship and often inseparable link between income tax and CGT and the prominent role of CGT in the trust context, the difficult decision was taken to remove CGT from the scope of the dissertation. The decision was based on the following factors:

First and foremost, the feasibility of the dissertation had to be ensured. Due to the complexity of the research topic, the time constraints within which the dissertation had to be completed, and the goal of keeping the dissertation within a reasonable length, it was not viable to include CGT as part of the discussion. If CGT had to be included, there would have been a high probability that both the income tax and CGT analysis would have been superficial, which would not have done either subject justice, or would it have met the standards appropriate for a doctoral dissertation. Thus, instead, it was decided to focus only on the income tax treatment of trusts and to ensure that the provisions are discussed in sufficient detail.

However, for purposes of this dissertation, reference is made to the possible application of CGT where relevant. This is merely to draw the reader's attention to the fact that in those specific circumstances, there may also be CGT considerations that have a bearing on the taxpayer's tax liability.

Although there are many similarities between the income tax provisions for trusts and the CGT counterparts, each set of taxes has a distinct application. The shortcomings may also overlap, but this does not mean that the same recommendations are relevant. It is likely that this may indeed be the case. However, this can only be determined with certainty after proper research has been done.

If one considers the relevance of CGT to trusts and the intricate nature of the subject, it is suggested that the aforesaid research issue could either form the basis of a separate doctoral dissertation, or I could possibly address these and other matters in potential future research projects.

Aside from CGT, the practical relevance of donations tax and estate duty for trusts should further be recognised. It is well known that one of the most widely used applications for trusts is for estate planning purposes. Thus, estate duty should always be a key consideration where trusts are concerned. Furthermore, trusts are often used to make provision for the maintenance of minor children. In these contexts, it is also important to be cognisant of the possible application and effect of donations tax. However, due to the same considerations mentioned in respect of CGT, the aforesaid

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taxes are not discussed. Instead, these taxes are only mentioned insofar as it is relevant to income tax and to the extent that it pertains to SAARs. Once again, these taxes and their relation to trusts can be explored in future research projects.

While traditionally transfer pricing is not applied to trusts, lately, this trend may have changed. This phenomenon can partially be attributed to the notion that trusts play an increasingly important role in commercial structures and cross-country transactions. This means that the transfer pricing regime is very much relevant to trusts and a pertinent consideration in practice. However, transfer pricing is also excluded from the dissertation's ambit and is not discussed.

Finally, the dissertation does not extend to tax evasion, anti-money laundering legislation and anti-terrorist finance provisions. Instead, the discussion is limited to tax avoidance. However, the more administrative type of anti-avoidance measures contained in the Tax Administration Act 28 of 2011, such as the Voluntary Disclosure Provisions and Reportable Arrangements provisions will not be addressed. Neither will the Foreign Account Tax Compliance Act ("FATCA"), common reporting standards ("CFCs"), treaties relating to the exchange of information and other double tax agreements. Although these other topics may be relevant in the greater scheme of things, they are not addressed in this dissertation.

In addition, for the purpose of this dissertation, it is assumed that an investor has already taken all other relevant factors and considerations into account, except for income tax, and that these factors give an equal result in comparison to other possible investment jurisdictions. This means that the determining factor for an investor revolves around the South African taxation of the trust's income, where the trust is an investment vehicle.

Moreover, this study does not consider investments in specific sectors of an economy but rather investments in general. On this note, it is recognised that the jurisdictions selected for comparison do not all share the same range of sectors nor the same economic (or other) strengths. Therefore, the study only focuses on the income tax framework of trusts.

1 5 Methodology

The dissertation follows a traditional legal research approach by consulting all major legal sources, for example, legislation, case law, administrative rulings, academic

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textbooks, journal articles and internet sources. In addition, it adopts a comparative research approach to the problem at hand. This entails identifying and analysing the key differences and similarities of the approaches followed in each of the selected jurisdictions and the reasoning behind the respective choices.

Furthermore, a functional research approach is incorporated into the study by referring to other jurisdictions from time to time, where it may be relevant or where those jurisdictions have a valuable contribution to make to the section. For example, the functional research approach is used in the chapter on tax havens, where a discussion of Mauritius's approach is incorporated. The motivation and reasoning stem from Mauritius's similarities with South Africa. For example, both South Africa and Mauritius form part of the emerging market economies.[96] They are also in close geographic proximity to one another.[97] Recently, Mauritius has also positioned itself as an attractive investment destination and a crucial gateway into Africa.[98] Evidence of this is Mauritius' competitive position on the ease of doing business index.[99] On many fronts, South Africa is, therefore, in direct competition with Mauritius for investment.[100] Mauritius has also modernised their trust legislation.[101] To this extent,

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[96] Country Economy "Country comparison Mauritius vs South Africa" (2019) *Country Economy* <https://countryeconomy.com/countries/compare/mauritius/south-africa> (accessed 27-10-2022).

[97] LW Bowman "Mauritius" (25-10-2019) *Britannica* <https://www.britannica.com/place/Mauritius> (accessed 27-10-2022).

[98] Standard Chartered Insights "Mauritius – investment gateway to Africa" (2014) *Standard Chartered Insights* <https://www.cim.mu/files/cgb/mauritius%20-%20investment%20gateway%20to%20africa%20(insights%20201314)%20a%20publication%20of%20standard%20chartered%20bank.pdf> (accessed 23-10-2022).

[99] Republic of Mauritius "Mauritius ranks 13th globally in the World Bank's Ease of Doing Business Report 2020" (24-10-2019) *Republic of Mauritius* <http://www.govmu.org/English/News/Pages/Mauritius-ranks-13th-globally-in-the-World-Bank's-Ease-of-Doing-Business-Report-2020.aspx> (accessed 28-10-2022).
World Bank Group "Doing Business 2020: Comparing business regulation in 190 economies" (2019) *Worldbank* <https://www.worldbank.org/content/dam/doingBusiness/country/m/mauritius/MUS.pdf> (accessed 28-10-2022).

[100] G Butchart "Why holiday island Mauritius is out-investing SA, and what we need to do about it" (16-04-2019) *Daily Maverick* <https://www.dailymaverick.co.za/article/2019-04-16-why-holiday-island-mauritius-is-out-investing-sa-and-what-we-need-to-do-about-it/> (accessed 28-10-2022); Fin24 "Mauritius the 'Singapore of Africa'" (07-07-2017) *Fin24* <https://www.fin24.com/Money/Investments/mauritius-the-singapore-of-africa-20170707> (accessed 28-10-2022); MoneyMarketing "Mauritius rolls out red carpet for foreign investors, residents" (22-11-2018) *MoneyMarketing* <https://www.moneymarketing.co.za/mauritius-rolls-out-red-carpet-for-foreign-investors-residents/> (accessed 28-10-2022).

[101] M Moller "Mauritius trust: an attractive investment vehicle for South Africa" (26-06-2018) *Appleby Global* <https://www.applebyglobal.com/publications/mauritius-trust-an-attractive-investment-vehicle-for-africa/> (accessed 28-10-2022).

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Mauritius has introduced an innovative trust framework.[102] There were also noteworthy changes to their tax system.

For the comparative legal method, a combination of approaches are used. However, throughout the dissertation, the emphasis remains the South African position. For the majority of the chapters, each jurisdiction is discussed in its entirety before continuing to the next jurisdiction. Those chapters conclude with a brief comparison of the jurisdictions discussed. This approach is adopted for chapters 2, 4 and 5. This is in contrast to the alternative approach, where each subject or topic is fully dealt with before progressing to the next. The author acknowledges that the former method may result in some duplication among jurisdictions, but that is an unavoidable consequence of ensuring a clear and comprehensive overview. However, it promotes consistency throughout the dissertation and, ultimately, the reading experience.

For chapters 3 and 6, the discussion uses a systematic approach. This means that instead of grouping the discussion according to the jurisdiction, the discussion addresses each topic before continuing to the next. This difference can largely be attributed to the nature of these two chapters' subject matter and objectives compared to the rest of the dissertation.

Belgium and the United Kingdom ("UK") were identified as the main jurisdictions for comparative research. It would have been preferable to also include a jurisdiction from the Southern African Development Community ("SADC") region, but due to the limited development and advancement in the taxation of trusts,[103] it would not have added any substantive value to the study. The same reasoning arguably applies to most other African countries that recognise the trust structure.

Belgium was selected due to the unique perspective it offers on trusts. As a civil law country, Belgium is not inherently familiar with the trust concept but was forced to regulate the use thereof as a result of the increasing popularity among residents. For example, the Cayman tax framework was introduced into Belgium's income taxation. This framework contains strict anti-avoidance provisions and allows Belgium to tax

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[102] Mitco "Mauritius – An innovative trust and estate planning jurisdiction" (16-03-2018) *Mitco* <https://mitcoworld.com/en/news/mauritius-innovative-trust-and-estate-planning-jurisdiction> (accessed 28-10-2022).

[103] I du Plessis "The taxation of trusts in SADC member states" (2018) 29 *Stell LR* 270-294. Mauritius is a notable exeption,where there have been many developments and innovations in respect of trusts.

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capital invested or accumulated outside the country. To a degree, it, therefore, also limits capital outflows. It should be considered whether South Africa should adopt a similar approach. In addition, Belgium uses a GAAR to aid the battle against tax avoidance. Belgium also forms part of the European Union ("EU"), which is an important trading partner for South Africa.[104]

The EU also takes decisions and passes directives and regulations that influence domestic legislation. All member countries, such as Belgium, are obligated to incorporate these directives into their legislation and take cognisant of the recommendations. The OECD has also embarked on a drive to combat tax avoidance by introducing various initiatives. Therefore, EU and OECD initiatives are also included in the research where applicable.

For purposes of this dissertation, the UK only refers to England and not Scotland, Wales and Northern Ireland. In contrast, the UK can be regarded as the origin of the trust concept. The UK has also recently enacted a GAAR in an attempt to curb tax avoidance. Furthermore, the UK has a well-developed body of tax law dealing with trusts and extensive and far-reaching specific anti-avoidance provisions.[105] The UK has been extremely successful in attracting FDI. Evidence of this is the fact that London is regarded as the financial capital of the world.[106]

Belgium and the UK, therefore, offer unique but pertinent perspectives from which South Africa might learn.

1 6 Dissertation overview

Apart from this introductory chapter, the dissertation further includes the following chapters:

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[104] A Jordaan & P Kanda "Analysing the trade effects of the EU-SA & SADC trading agreements: a panel data approach" (2011) 14 *SAJEMS* 229-244; Parliamentary Monitoring Group "South African-European Union Trade, Development & Co-operation Agreement: briefing" (16-09-1999) <https://pmg.org.za/committee-meeting/4425/> (accessed 27-10-2022).

[105] HM Treasury "Tackling tax avoidance, evasion, and other forms of non-compliance" (03-2019) *HM Treasury* <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/785551/tackling_tax_avoidance_evasion_and_other_forms_of_non-compliance_web.pdf> (accessed 27-10-2022).

[106] Talk Business "Why London is the financial capital of the world" (2018) *Talk Business* <https://www.talk-business.co.uk/2018/11/01/why-london-is-the-financial-capital-of-the-world/> (accessed 23-10-2022).

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Chapter 2: Essential aspects of trusts

This chapter provides an overview of the trust law applicable in each of the selected jurisdictions. It also serves as a background to further topics in the study. It focuses on the key aspects of the trust entity. This includes the parties to a trust, the legal nature of a trust, types of trusts, methods of formation, duration of trusts, requirements of a trust, the office of trusteeship, the trust administration, investments by trusts and the legal standing of a beneficiary. It compares the different approaches adopted in the different jurisdictions towards the governing of trusts to identify areas where the current South African legislation can be improved. This is achieved by highlighting each jurisdiction's core similarities and differences.

Chapter 3: Tax havens

This chapter provides an overview of the concept of "tax havens". It commences with a discussion of the background to tax havens, followed by their characteristics, terminology and definitions. The question of why tax havens exist is then addressed before the discussion turns to the concept of quasi-tax havens. First, the notion is discussed, whereafter the United States of America and Belgium are evaluated as possible quasi-tax havens. This is followed by an analysis of tax havens' possible advantages and disadvantages. Next is an overview of the Mauritian tax framework and trust regime. Furthermore, the initiatives the OECD and other organisations embarked upon to try and curb the existence of tax havens are discussed. These initiatives are evaluated. This chapter also briefly examines which countries become tax havens and under what circumstances. This provides a clear picture of the offerings available. It serves as a benchmark for South Africa to gauge its attractiveness as an investment destination. This allows for identifying key areas where South Africa can improve upon.

Chapter 4: Taxation of trusts

This chapter examines how trusts are treated for income tax purposes in each jurisdiction. The discussion commences with an overview of the different approaches available to trust taxation. The chapter further includes topics such as the legal nature of trusts for tax purposes, in whose hands income is taxable, different tax treatment for different types of trusts, the responsibility for tax administration, determining

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residence status, the conduit pipe principle, the taxation of the trust parties and an overview of the GAAR. The discussion concludes with a brief comparison of the different jurisdictions and a discussion of the similarities and differences. The outcomes are analysed, and possible explanations provided. The results are then used to identify potential areas for reform.

Chapter 5: Specific anti-avoidance rules

This chapter analyses and evaluates the various SAARs applicable to trusts in each jurisdiction. The study attempts to determine the current provisions' effectiveness by identifying each provision's strengths and weaknesses. This is done by comparing the different mechanisms used in the main jurisdictions. The key overlaps and differences are subsequently discussed. The results are applied to identify areas and ways in which the current South African approach can be improved upon.

Chapter 6: Conclusion and recommendations

The results and conclusions reached in the dissertation are discussed and analysed. This chapter then makes recommendations based on the insights gained from previous chapters. The recommendations are coupled with the potential outcomes that could be achieved. It also identifies areas for further research before reforms can be suggested.

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CHAPTER 2: ESSENTIAL ASPECTS OF TRUSTS

2 1 Background

This chapter introduces the trust concept and provides a thorough overview of each jurisdiction's trust law. The goal is to discuss and highlight the main similarities and differences between the approaches adopted in the main jurisdictions. This serves as the background and foundation for subsequent chapters. Due to the complexity of the dissertation's subject, it is paramount to have a reasonable understanding of trust law before focusing on tax matters. In addition, throughout the chapters, references are made to trust terminology and concepts when discussing related topics.

These objectives are achieved by addressing the following questions:

1. Who are the parties to a trust, and what are their respective roles?
2. Is a trust a legal entity? If not, how does it work?
3. How is a trust formed?
4. Are all trusts the same, or what types of trusts are available?
5. How long does a trust exist, or are there limitations?
6. What are the requirements to create a trust?
7. How does the administration of a trust work? Who are the responsible parties?
8. Can trust funds be invested, or are there restrictions?

The intention is not to discuss every possible aspect of trust law, explore each topic in detail or seek answers to the multifaceted debates and controversies currently raging among the academic fraternity. [1] The objectives are merely to prepare the reader for the discussions that will follow. This chapter adheres to the majority views, but reference is made to conflicting perspectives where appropriate. This will ensure an accurate picture of the current position while also indicating areas that are still under discussion or where there is no consensus at this stage.

This chapter follows the methodology explained in chapter 1, in which each of the three jurisdictions is discussed in their entirety before moving on to the next jurisdiction. The author acknowledges that it may result in some duplication among jurisdictions, but that is an unavoidable consequence of ensuring a clear and

[1] M de Waal "Anomaliee in die Suid-Afrikaanse trustreg"(1993) 56 *THRHR* 1 ff.

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comprehensive overview while maintaining consistency throughout the rest of the dissertation.

2 2 Introduction

Among the common-law countries, the trust concept is no strange phenomenon. The trust form has become intertwined with everyday life to such an extent that many transactions would not be possible, or at least substantially more complex, if not for the existence of trusts.

Some of the prominent jurisdictions that have embraced the trust concept include the United States of America ("USA"), Canada, Australia and New Zealand.[2]

In recent years, the popularity of the trust structure has even spread to traditional civil law countries as well.[3] The extent to which such countries have contributed to or have embraced trusts differs substantially. In some instances, they have enacted their own trust law, only legislation regulating the use of foreign trusts, or created a new trust-like entity entirely. Some examples include Italy, Belgium and France.

In addition, extensive work has been done on a continental level to create a universally excepted civil law trust framework. The latter is particularly true in the European area.[4] Similarly, there has been a drive to try and consolidate trust legislation amongst the different states in the USA.[5]

Moreover, the rise in the popularity of trusts, coupled with the unique nature thereof, led to the emergence of an international trust dimension. This means it has become necessary to regulate the circumstances under which trusts from different jurisdictions are recognised and to establish the applicable laws in each instance.[6]

For this reason, the question arises as to why the trust structure is so appealing. The answer to this question is not a simple one. The best way to address the question

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[2] DJ Hayton *Fundamental Principles of Law: The Law of Trusts* 4 ed (2003) 1.
[3] M Graziadei, U Mattei & L Smith *Commercial Trusts in European Private Law* (2005) 5; DJ Hayton "The Developing European Dimension of Trust Law" (1999) 10 *KLJ* 48-70.
[4] DJ Hayton, SCCJJ Kortmann & HLE Verhagen *Principals of European Trust Law* (1999) 215; C von Bar, E Clive & H Schulte-Nölke *Principals, definitions and model rules of European Private Law* (2009) 89.
[5] The National Conference of Commissioners on Uniform State Laws "Summary" (2000) *NCCUSL* <http://www.nccusl.org/Update/uniformact_summaries/uniformacts-s-utc2000.asp> (accessed 02-11-2022).
[6] Hague Conference on Private International Law "Convention on the Law Applicable to trusts and on their recognition" (1985) *HCCH* <https://www.hcch.net/en/instruments/conventions/full-text/?cid=59> (accessed 02-11-2022).

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is to briefly examine the uses of trusts. More than one reason may be applicable in one specific case. It should be noted that different jurisdictions may not necessarily classify trusts in the same manner. Some may further subdivide these broad categories into more specialised forms. Trusts in South Africa are malleable entities that can be used in various ways, and for this reason, there are many applications of a trust.[7] The trust is an "all-purpose institution" and can be used to service an indefinite number of scenarios.[8] As a point of departure, trusts can be divided into the following main categories:

1. Preservation of wealth:[9] It enables the accumulation of wealth over generations. This wealth is usually managed and invested for the benefit of the family. It also serves an asset protection function. It can be protection against certain creditors or even protection against family members who cannot control their spending.
2. Tax planning:[10] To structure their affairs or transactions in such a way as to minimise possible tax liability.
3. Financial transactions:[11] Trusts can be used as an alternative ownership structure for a business. Furthermore, it may enable collective investments such as pension funds and unit trusts. In addition, it can be used to secure commercial debt. It also allows groups of people to share in the ownership of an enterprise, such as the employee share schemes or the broad-based black economic empowerment ("B-BBEE") trusts.[12]
4. Maintenance:[13] A trust is often used to take care of a spouse or children if the marriage breaks down. It can further be used when the parents are deceased or to manage the affairs of those unable to take care of themselves.
5. Not for profit:[14] The trust entity enables a group of people to form an association or club for a shared purpose or goal. Trusts are also used by charities which aim to further a specified cause.

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[7] E Cameron, MJ de Waal & M Solomon *Honoré: The South African Law of Trusts* 6 ed (2018) 14-17.
[8] 14-17.
[9] J Garton *Moffat's Trusts Law: Text and Materials* 6 ed (2015) 1.
[10] SM Brink "An investigation into the future of discretionary trusts in South Africa: An income tax perspective: Part 2" (2017) 20 *SSJEMS* 1-12.
[11] Garton *Moffat's Trusts Law: Text and Materials* 1.
[12] Broad Based Black Economic Empowerment Act 53 of 2003 ("B-BBEE Act").
[13] Brink (2017) *SSJEMS* 4.
[14] MJ de Waal "Trust and fiduciary mechanisms" in R Blanpain (ed) *International Encyclopaedia of Law* (2015) 1122.

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The above list is by no means exhaustive. Furthermore, as societal needs, policy frameworks, and external circumstances change, so does the application of the trust.[15] There are always new and innovative ways in which trusts are used to address a specific need or problem. With this ever-evolving landscape, some jurisdictions try to capitalise on this trend by revamping legislation and introducing novel trust forms aimed at solving a specific goal or target market.

However, this does not mean the trust is without controversy or criticism.[16] Over the last two decades, the range and frequency of illegal or questionable applications of trusts have also increased.[17] The same vital aspects of the trust structure that many praise also make it possible (and appealing) to be abused, for example, for tax evasion, money laundering and terrorist finance.

2 3 South Africa

The trust idea was introduced to South Africa during the British occupation.[18] Shortly thereafter, the courts had to pronounce on cases where trusts were used.[19] Over time, the courts developed the South African trust law. Many concepts and doctrines were incompatible with the legal system and either disregarded or modified.[20] In later years, the legislator intervened by codifying certain aspects.[21] Based on the aforementioned, a truly and uniquely South African trust regime came into existence.

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[15] E Cameron, MJ De Waal, Solomon, *Honoré: The South African Law of Trusts* 6 ed (2018) 16.

[16] The International Consortium of Investigative Journalists "The Panama Papers: Exposing The Rogue Offshore Finance Industry" (undated) *ICIJ* <https://www.icij.org/investigations/panama-papers/> (accessed 02-11-2022).

[17] A Knobel "Trusts, weapons of mass injustice?" (2017) *TJN* 1-60.

[18] UK Parliament "The settler colonies: South Africa" <https://www.parliament.uk/about/living-heritage/evolutionofparliament/legaslativescrutiny/parliament-and-the-american-colonies-before-1765/the settler-colonies-south-africa/ (accessed 26-04-2023).

[19] *Twentyman v Hewitt* (1833) 1 Menz 156; *Batt v Batt's Widow* (1835) 2 Menz 408.

[20] *Braun v Blann & Botha* NNO 1984 2 SA 850 (A) 866-867).

[21] Section 1 of the TPCA. The Trust Moneys Protection Act 34 of 1934.

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2 3 1 Parties to a trust

2 3 1 1 The founder

In South Africa, the founder of a trust is the party who establishes the trust. It is possible for a trust to have co-founders.[22] The founder can be either a natural or juristic person as long as the person has the necessary capacity to act.[23] The founder creates the trust deed in which all the trust terms, guidelines and conditions are outlined.[24] In most instances, the founder will provide the trust's initial property.[25] It is crucial that the founder relinquishes the control of the property to the trustee.[26] The founder may also be a trustee, beneficiary or both. The only restriction is that the founder cannot be the sole trustee and sole beneficiary.[27] In South Africa, there is no limitation on the property that the trust can hold.[28]

2 3 1 2 The trustee

In terms of South African law, the trustee is the party who manages the trust.[29] The trustee is required to hold, control and administer the trust property, not for his own benefit, but for the benefit of the trust's beneficiaries or in fulfilment of an impersonal object as stipulated by the founder in the trust deed.[30] Even though it is possible to have a sole trustee, it is seldom the case in practice.[31] The trustee may also be a beneficiary of the trust.[32]

In South Africa, the office of trusteeship is well regulated. As a point of departure, there is no set limit on the maximum number of trustees.[33] Moreover, it is a requirement that a trust must have an independent trustee. This ensures that the

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[22] F du Toit *South African Trust Law – Principles and Practice* 2 ed (2007) 5.
[23] Cameron, De Waal & Solomon *Honoré: The South African Law of Trusts* 5.
[24] 5.
[25] 5.
[26] 6.
[27] *Land and Agricultural Development Bank of South Africa v Parker* 2004 4 All SA 261 (SCA) para 19; *Nel v Metequity Ltd* 2007 3 SA 34 (SCA); *Groeschke v Trustee, Groeschke Family Trust* 2013 3 SA 254 (GSJ).
[28] Cameron, De Waal & Solomon *Law of Trusts* 6.
[29] Section 1 of the TPCA.
[30] Cameron, De Waal & Solomon *Honoré Law of Trusts* 8.
[31] Du Toit *South African Trust Law* 5.
[32] *Land and Agricultural Development Bank of South Africa v Parker* 2004 4 All SA 261 (SCA) para 19.
[33] F du Toit *South African Trust Law Principles and Practice* (2002) 61.

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separation between control and enjoyment is maintained.[34] Where there is no independent trustee, the trust will not be invalid on that basis, but the courts may well regard the trust as the alter ego of the founder. This means that the trust structure will be disregarded in its entirety. This is especially paramount where the parties to the trust are related, such as in a family trust scenario.[35] This occurrence forms part of the broader abuse of trust theme. It is often confused with the so-called sham trust.[36] The former revolves around the disregard of trustees' responsibilities or the improper administration of the trust.

Depending on the circumstances, a trustee can be appointed by various entities such as the founder, the high court, the Master, statutes and other trustees or beneficiaries.[37] In order to become a trustee, it is necessary that the nominee accepts the appointment.[38] As a general rule, no trust will fail as a result of the lack of a trustee.[39] In South Africa, there is no qualification requirement to become a trustee. Generally speaking, anyone can be a trustee in South Africa. A trustee may either be a natural or juristic person, such as a company.[40] The only formal requirement for trusteeship is the furnishing of security to the satisfaction of the Master.[41] However, the grounds for removal in the Trust Property Control Act 57 of 1988 ("TPCA") may be interpreted as a qualification for trusteeship.[42]

[34] *Land and Agricultural Development Bank of South Africa v Parker* 2004 4 All SA 261 (SCA) 267b.
[35] 267b.
[36] MJ de Waal "The abuse of the trust (or: 'going behind the trust form'): The South African experience with some comparative perspectives" (2012) 76 *TRJC& IPL* 1078-1100. BS Smith "Sham trusts in South Africa: Tempora mutantur, nos et mutamur in illis (times change, and we change with them" (2019) 136 *SALJ* 550-580.
[37] Du Toit *South African Trust Law* 61.
[38] Cameron, De Waal & Solomon *Honoré Law of Trusts* 182-213.
[39] WD Geach & J Yeats *Trusts Law and Practice* (2007) 79.
[40] R King, L van Vuuren, W M van der Westhuizen & M Botha *Estate Planning and Fiduciary Services Guide* (2016) 251.
[41] 251.
[42] Section 20 of the TPCA.

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According to the TPCA,[43] any person appointed as a trustee shall only act in that capacity if authorised in writing by the Master.[44] This provision has been interpreted to mean that any juristic act by a trustee without authorisation will be deemed null and void,[45] and subsequent ratification or validation is not possible. In addition, the court has held that this requirement extends to the institution of legal proceedings on behalf of a trust.[46] The unauthorised trustee lacks the necessary legal standing, and the result thereof means that the action will also be invalid.[47]

The fiduciary nature of trusteeship may require that security be provided for the proper administration of the trust.[48] The position is similar to curators, tutors or executives. This obligation may be waived by the trust instrument, the Master or the court.[49] The Master has a wide discretion regarding the furnishing of security. This includes exempting a trustee or reducing, cancelling or ordering additional security.[50]

2 3 1 3 The beneficiary

The beneficiary is the party or parties who directly benefit from the trust.[51] South African beneficiaries can be determined by name, through the degree of consanguinity, from a specific class or an impersonal object.[52] There is no limitation or restriction regarding who may be a beneficiary; it is strictly the founder's prerogative.[53]

In South Africa, the nature and extent of the beneficiary's rights depend on the type of trust, subject to the specific provisions of the trust instrument. Beneficiaries are

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[43] Section 6(1); BS Smith "Section 6(1) of the Trust Property Control Act 57 of 1988 revisited: establishing its nature and re-emphasising the validity of the 'dual purpose' theory" (2011) 22 *Stell LR* 315; MC Wood-Bodley "That devilish little point – The impact of section 6(1) of the Trust Property Control Act 57 of 1988 on the capacity of trustees to contract, sue, and be sued: Lupacchini No & Another v. Minister of Safety and Security" (2011) *SALJ* 128, 210.
[44] *Metequity Ltd v NWN Properties Ltd* 1997 4 All SA 607 (T); *Deedat v Master of the Supreme Court* 1997 3 All SA 260 (N); *Watt v Sea Plant Products Bpk* 1998 4 All SA 86 (C); *Lupacchini NO and Another v Minister of Safety and Security* 2010 6 SA 457 (SCA).
[45] Du Toit *South African Trust Law* 35. *Simplex (Pty) Ltd v Van der Merwe* 1996 1 SA 111 (W).
[46] 35.
[47] 35.
[48] 108.
[49] Geach & Yeats *Trusts Law and Practice* 21.
[50] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1122.
[51] King et al *Estate Planning and Fiduciary Services* 251.
[52] Cameron, De Waal & Solomon *Honoré Law of Trusts* 6.
[53] 3. *Kohlberg v Burnett NO* 1986 3 SA 12 (A).

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often divided into two categories, namely income or capital beneficiaries.[54] In the case of an income beneficiary, the beneficiary has a claim for payments of trust income.[55] Capital beneficiaries have a claim to the trust capital. The transfer thereof is usually subject to certain conditions or only at the termination of the trust.[56]

The rights of beneficiaries are either vested or contingent. Vested rights are immediately enforceable.[57] Therefore it is not subject to a condition or contingency. Such right automatically forms part of the beneficiary's estate and can be transferred or attached. In the case of a contingent right, the opposite is true.[58] The right can only be realised once all conditions are fulfilled.[59] In the case of a discretionary trust, the beneficiaries' benefit is contingent on the trustees exercising their discretion in favour of set beneficiary or beneficiaries. This means that no right exists if the trustees do not exercise their discretion or until the trustees do and if it is not in favour of the beneficiary. The determination of how and when vesting occurs depends on the trust instrument.

2 3 1 4 The protector and enforcer

In addition to the above-mentioned parties, in certain circumstances, some jurisdictions provide for the appointment of a protector and/or an enforcer.[60] This is typically encountered in so-called tax haven jurisdictions. The addition of the protector and enforcer to a trust is often used to retain greater control over the trust assets by the founder.[61] The office of the protector has a fiduciary duty to advise and supervise the trustees.[62] The protector can be either a natural or legal person with the required capacity to act.[63] Subject to the trust instrument and instances where there is more than one protector, the majority rule is applicable.[64] It is permissible for the protector to be a founder, trustee or beneficiary. The enforcer must enforce the terms and

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[54] King et al *Estate Planning and Fiduciary Services* 251.
[55] Du Toit *South African Trust Law* 5.
[56] 5.
[57] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1137.
[58] Geach & Yeats *Trusts Law and Practice* 21.
[59] 21.
[60] TH Tey "The duties of a trust enforcer" (2010) 22 *SAcLJ* 363.
[61] 99.
[62] 365.
[63] LA Frolik "Trust protectors: why they have become the next best thing" (2015) 2 *RPT&ELJ* 267.
[64] 268-269.

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purposes of the trust.[65] All the formal requirements regarding an enforcer's valid appointment and resignation must be adhered to.[66] The enforcer is entitled to all documents and records so as to perform his functions satisfactorily.[67] Moreover, the enforcer is expected to exercise his powers and duties fiducially. Finally, the enforcer may not be a trustee.[68]

Unlike other jurisdictions, the concepts of protector and enforcer are foreign to South Africa.[69] The TPCA makes no mention of or reference to either. The question then arises, is it possible to include such a party in a South African trust? It is clear that there is no outright bar to such inclusion. However, the extent to which the courts will accept and recognise such provision in a trust deed is unknown. This may largely depend on the powers and duties conferred on the protector or enforcer. The risk, however, remains for severe adverse consequences should the court reject the concept in its entirety. The court may elect to strike out the specific clause or decide to nullify the trust as a whole.

The nature of the South African trust may explain the reason for the aforementioned. The core concept of a trust in South Africa is that a person holds property for the benefit of another.[70] In this construct, the fundamental nature of a trust is the separation between ownership and enjoyment. The former statement gets blurred as soon as another party is introduced to the equation. Or in other words, it dilutes the strict separation that is required. If a protector or enforcer was recognised in South Africa, it might result in the founder indirectly exercising control over the trust. This will not be desirable, seeing that one of the requirements is that the founder should relinquish all control over the trust property.[71] It can be argued that a protector and enforcer could actually strengthen the administration of a trust by ensuring that the trust deed and wishes of the founder are followed. This may be true in most cases, but the possibility of abuse remains high. In order to mitigate against such risk, it will be necessary for proper regulation in this regard. One possible solution may be to make it a requirement that the protector and enforcer must be independent. In other

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[65] Tey (2010) *SAcLJ* 367.
[66] 367.
[67] 368-369.
[68] 376.
[69] M Honiball & L Oliver *The Taxation of Trusts in South Africa* (2009) 38.
[70] *Land and Agricultural Development Bank of South Africa v Parker* 2004 4 All SA 261 (SCA) 267b.
[71] Cameron, De Waal & Solomon *Honoré Law of Trusts* 11.

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words, it cannot be someone that is related or connected to the founder, trustees or beneficiaries. This will allow for positive consequences to prevail while limiting the risk of abuse.

2 3 2 The legal nature of a trust

In South African law, a trust cannot be classified as a natural or juristic person. Rather, it is something between these two entities.[72] The courts have repeatedly held that trusts are not juristic persons.[73] Despite the classification, a trust shares many characteristics that are similar to a legal person.[74] This also leads to various anomalies occurring in practice.[75] In certain circumstances, specific legislation treats trusts as legal persons.[76] In the absence of such legislation, a trust constitutes a separate estate.[77] The trust itself cannot be the owner of assets, but rather the trustees, in their official capacity, are the owners.[78] This forms the core idea of a trust, namely the separation between ownership or control and enjoyment.[79] It is especially this aspect that distinguishes trusts from other entities.[80] This unique feature allows for unmatched flexibility and adaptability.

2 3 2 1 Variation of a trust

The *inter vivos* trust has been held to be a contract between the founder and the trustees for the benefit of another.[81] Following from the former, the beneficiaries have no right to the trust property until they have accepted the benefit under the trust offered to them.[82] To this extent, the founder and trustees can amend or revoke the trust deed upon mutual agreement before the acceptance of the beneficiaries, depending on the

[72] RP Pace & WM van der Westhuizen *Wills and Trusts* (October 2012) – B8.5 at 44(9).
[73] *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA).
[74] BA van der Merwe "The phrase 'place of effective management' effectively explained" (2006) 18 *SA Merc LJ* 121.
[75] *Land and Agricultural Bank of South Africa v Parker* 2005 2 SA 77 (SCA) 83.
[76] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1108.
[77] Cameron, De Waal & Solomon *Honoré Law of Trusts* 66.
[78] 10-11.
[79] De Waal Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1107.
[80] 1107.
[81] *C.I.R v Estate Crewe* 1943 AD; *Crookes NO and Another v Watson* 1956 1 SA 277 (A); *Hofer v Kevitt NO and Others* 1998 1 SA 382 (A); *Potgieter v Potgieter NO and Others* 2012 1 SA 637 (SCA).
[82] *Van der Plank NO v Otto* 1912 AD 353.

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terms of the trust deed.[83] In addition, there is a wide range of circumstances under which a trust deed can be changed, each with its own requirements and processes.[84]

In the case of testamentary trusts, the trust deed can be varied under specific circumstances.[85]

2 3 2 2 Ownership of trust property

At the death of a trustee, the trust property does not form part of the trustee's personal estate but is kept separate by the executor of the trustee's estate. The executor must safeguard the trust property until a new trustee has been appointed. The trust property is unaffected if there is more than one trustee.[86]

It is important to observe that the concept of equitable ownership is not recognised in South African law, as is the case in English law.[87] It is clear that the English law of trusts has not been subsumed in South Africa.[88] Instead, the courts have developed a uniquely South African trust. It is undeniable that English influence played a role in shaping the former, but substantial differences remain.[89]

In South Africa, beneficiaries only have a personal right against the trustees.[90] The aforesaid allows the beneficiaries to ensure that the trust is administered in accordance with the stipulations of the trust deed.[91] This serves as a way to safeguard their interest or potential benefit under the trust. This personal right further confers the

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[83] *Crookes NO and Another v Watson* 1956 1 SA 277 (A).
[84] Sections 4(2), 13, 14 and 33(1) of the TPCA. General Law Amendment Act 62 of 1955; Immovable Property (Removal or Modification of Restrictions) Act 94 of 1965; *Groeschke v Trustee, Groeschke Family Trust* 2013 3 SA 254 (GSJ); *Potgieter v Potgieter NO and Others* 2012 1 SA 637 (SCA); *Hanekom v Voight NO and Others* 2016 1 SA 416 (WCC); *Jewish Colonial Trust Ltd v Estate Nathan* 1940 AD 163; *Ex parte Watling* 1982 1 SA 937 (C); *Gowar v Gowar* 2016 5 SA 225 (SCA).
[85] *Minister of Education v Syfrets Trust Ltd* 2006 4 SA 205 (C); *Ex Parte BOE Trust Ltd* 2009 6 SA 470 (WCC); *BOE Trust Ltd* NNO 2013 3 SA 236 (SCA); *Curators, Emma Smith Educational Fund v University of KwaZulu-Natal* 2010 6 SA 518 (SCA); *Heydenrych Testamentary Trust* 2012 4 SA 103 (WCC); *William Marsh Will Trust* 1993 2 SA 697 (C).
[86] MJ de Waal "The strange path of trust property at a trustee's death: theory and practice in the law of trusts" (2009) 1 *JoSAL* 84-101.
[87] *Braun v Blann and Botha NNO and Another* 1984 2 SA 850 (A).
[88] MJ de Waal "The core elements of the trust: Aspects of the English, Scottish and South African trusts compared" (2000) 117 *SALJ* 548-571.
[89] *Twentyman v Hewitt* (1833) 1 Menz 156; *Estate Kemp v Mcdonald's Trustee* 1915 AD 491; *Braun v Blann and Botha NNO and Another* 1984 2 SA 850 (A); *Crookes NO v Watson* 1956 1 SA 277 (A).
[90] De Waal (2000) *SALJ* 555.
[91] *Mariola v Kaye-Eddie NO and Others* 1995 2 SA 728 (W); *Gross v Pentz* 1996 4 SA 617 (SCA); *Bafokeng Tribe v Impala Platinum Ltd* 1993 3 SA 517 (BH); *Giantsos NO v Giantsos* 2015 JDR 1642 (GJ); *Breetzke v Alexander* (12922/14) [2015] ZAKZPHC 44 (8 September 2015).

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beneficiaries with the necessary *locus standi* to take legal action against the trustees if the trustees do not act within the parameters of the trust deed.[92]

Furthermore, the legal title is held by the trustees, or by someone else on their behalf, for the benefit of the beneficiaries.[93] This enables beneficiaries to enjoy the trust property without having any real right thereto. The trust property does not form part of either the beneficiaries' or the trustees' personal estate.[94]

This means that all trust property is protected from the trustee's private creditors.[95] Therefore, the trust cannot be held responsible for debts incurred by trustees in their private capacity.[96] The notion is also extended to claims by or against beneficiaries. This results in a situation where trust property remains outside the reach of beneficiaries' creditors unless the distribution is no longer conditional. Put differently, if vesting has occurred, the beneficiaries' creditors will be able to attach the distribution made by the trust. In such a case, the creditors can only attach that specific benefit. However, most trust deeds will make provision for the trustees to apply their discretion so that no distribution is made to a beneficiary if their financial position poses a risk to the trust assets. Similarly, the trust's creditors are limited to trust property only and have no claim to the beneficiaries or the trustee's property in their private capacity.[97] The exact consequences are still unknown should trustees mix their private property with that of the trust or if they fail to clearly keep the trust's property separate and identifiable. One will have to wait for the courts for clarity in this regard. It should be remembered that one of a trustee's core duties is to keep trust property separate and identifiable from his own.[98] Furthermore, the trustees are only entitled to trust assets if they are, and to the extent that they are also beneficiaries of the trust.[99] In addition, any donation made to a trust is regarded as a donation to the trustees in their official capacity.[100] Trustees are also permitted to make a donation, in their personal capacity, to themselves in their official capacity.[101]

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[92] F du Toit "The fiduciary office of trustee and the protection of contingent trust beneficiaries" (2007) 18 *Stell LR* 469.
[93] *Estate Kemp v McDonald's Trustee* 1915 AD 491.
[94] Section 12 of the TPCA.
[95] Cameron, De Waal & Solomon *Honoré Law of Trusts* 10.
[96] 10.
[97] 7-8.
[98] Sections 10 and 11 of the TPCA.
[99] Cameron, De Waal & Solomon *Honoré Law of Trusts* 5.
[100] 7-8.
[101] Du Toit *South African Trust Law* 5.

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2 3 2 3 Practical considerations

Moreover, a trust cannot be held liable in criminal proceedings but rather the trustees in their official capacity.[102] Equally, this explains why a trustee must institute legal action in his official capacity if the matter concerns the trust assets.[103]

A trust is regarded as a debtor under insolvency legislation.[104] Therefore, a trust can be sequestrated.[105] It is also regarded as proper practice for immovable property to be registered in the name of the trust.[106] Likewise, the notion of citing the trust in litigation matters has recently become common practice.[107] In addition, a trust can be a principal debtor, and any surety agreement for such debts is valid and enforceable.[108]

2 3 3 Types of trusts

The criteria used for classifying trusts are fundamental in determining the types of trusts. Loosely stated, this means there is no set list of types of trusts.[109] The grounds of trust classification are ownership, types of rights associated with beneficiaries, purpose and method of formation.[110]

2 3 4 Categories of trusts

In South Africa, there are currently two overarching categories of trusts: *bewind* trusts and ownership trusts. Under a *bewind* trust, the beneficiaries are the owners of the trust property. This means that the beneficiary has a real right in the trust property.[111] This puts the trust beneficiary in a superior position should a breach of trust occur. In

[102] Cameron, De Waal & Solomon *Honoré Law of Trusts* 7-8.
[103] 7-8; *Rosner v Lydia Swanepoel Trust* 1998 2 SA 123 (W); *Watt v Sea Plant Products Bpk* 1998 4 All SA 86 (C); *Lupacchini NO and Another v Minister of Safety and Security* 2010 6 SA 457 (SCA); *Land and Agricultural Development Bank of South Africa v Parker* 2005 2 SA 77 (SCA).
[104] *Magnum Financial Holdings (Pty) Ltd v Summerly* NO 1984 1 SA 160 (W).
[105] *Mellville v Busane* 2012 1 SA 233 (ECP) para 10.
[106] Cameron, De Waal & Solomon *Honoré Law of Trusts* 7-8; *Joubert v Van Rensburg* 2001 1 SA 753 (W); *Mkangeli v Joubert* 2002 4 SA 36 (SCA).
[107] Cameron, De Waal & Solomon *Honoré Law of Trusts* at 7-8.
[108] *BoE Bank Ltd v Ries* [2002] 2 All SA 247 (A); *Knox Property Trust* 1999 1 All SA 425 (D).
[109] PA Olivier S Strydom & GPJ van den Burg *Trust Law and Practice* (2014) 5.
[110] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1109.
[111] King et al *Estate Planning and Fiduciary Services* 253.

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such construction, the role of the trustees is limited to the management and control of the trust property.[112] The beneficiaries also have a personal right against the trustees to enforce their duties. This form of trust is not commonly applied in practice and will therefore not be further discussed in this dissertation. Conversely, in terms of an ownership trust, the beneficiaries have no real right in the trust property.[113] Instead, the ownership and control lie with the trustees, in their official capacity, in the best interest of the beneficiaries or the trust object.[114] Even though under South African law, beneficiaries do not have such an extensive arsenal of remedies to their disposal as in the case of the United Kingdom ("UK").[115] This does not necessarily leave the beneficiaries in a weaker position should a breach of trust occur. Notwithstanding the limited remedies available, the South African trust law does offer adequate protection for beneficiaries.[116] Equally, this same aspect makes the trust structure so attractive. The beneficiaries have a personal right against the trustees to ensure that they comply.[117]

2 3 4 1 Ownership trusts

The ownership trust is the most widely applied trust form and exists in the following forms:

1. Discretionary trust – beneficiaries do not have fixed entitlement or interest in the trust property. The trustees have the discretion to determine whether, to whom and how much of the assets, income and capital of the trust must be distributed to the beneficiaries.[118] Until the trustees exercise their discretion, the beneficiaries have only a contingent right to the trust property.[119]
2. Vesting trust – certain beneficiaries have a legal right to the trust income and/or the trust capital. The trustees have no discretion whether to, when or to whom to make a distribution. All distributions must be made as stipulated in the trust

[112] 253.
[113] Du Toit *South African Trust Law* 3.
[114] Geach & Yeats *Trusts Law and Practice* 19.
[115] De Waal (2000) *SALJ* 556.
[116] 556.
[117] Du Toit *South African Trust Law* 179.
[118] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1109.
[119] See paragraph 2 3 1 Parties to a trust.

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deed.[120] The beneficiaries can enforce their entitlement under the trust. In addition, the beneficiaries' interest in the trust property forms part of their personal estate.[121]

3. Business trust – this is where the trust structure is used as an alternative to partnerships, companies or close corporations to actively trade or run an enterprise to make a profit.[122]
4. Unit trust – a collective investment scheme or unit trust is an investment vehicle where individuals or small investors can pool their resources, and trustees are then able to combine the cash and invest it on behalf of the group.[123]
5. Charitable trust – these trusts serve impersonal objects. Examples hereof are bursaries and research funding.[124]

2 3 4 2 Methods of formation

In South Africa, there are various means by which a trust can be created – these may be through a will, court order, contractual agreement or statutes.[125] A trust instrument is defined in the TPCA as "a written agreement or a testamentary writing or a court order according to which a trust was created".[126] The trust instrument constitutes the foundation on which the trust is built. It contains the terms, conditions, purpose and guidelines by which the trustees must function. The method by which a trust is established does not determine the type of trust, but rather the type of trust is dependent on the factors listed in paragraph 2 3 3 Types of trusts above.[127]

1. Contractual agreement – a trust formed during the founder's lifetime is referred to as an *inter vivos* trust.[128] This is based on a *stipulatio alteri*, a contract for the benefit of a third party.[129] It is a bilateral act between the founder and prospective trustees. In theory, it is possible to create an *inter vivos* trust by oral agreement,

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[120] Moore Stephens "Trust Guide 2018-2019 – live long and sensible" <https://southafrica.moorestephens.com/MediaLibsAndFiles/media/southafricaweb.moorestephens.com/Guides/Moore-Stephens-Trust-Guide-Digital.pdf> (accessed 09-03-2022).
[121] See paragraph 2 3 1 Parties to a trust.
[122] Olivier et al *Trust Law and Practice* 5-17.
[123] Cameron, De Waal & Solomon *Honoré Law of Trusts* 618-645.
[124] Honiball & Oliver *The Taxation of Trusts in South Africa* 207.
[125] De Waal Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1106-1107.
[126] Sections 4 and 7 of the TPCA.
[127] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1110.
[128] 1110.
[129] Olivier et al *Trust Law and Practice* 3.

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but the TPCA would not recognise this.[130] Rather, it would be governed by the common law. The trust instrument of an *inter vivos* trust is commonly known as the trust deed.[131]

2. By will – a trust established by the testator in his will is called a *mortis causa trust*, commonly known as a testamentary trust.[132] Such a trust constitutes a testamentary disposition. For this reason, the will must be validly executed in accordance with the prescribed formalities contained in the Will's Act 7 of 1958. The position of the trustee can be equated to the position of a burdened legatee.[133] The trustee receives the property but is obliged to administer the testamentary bequest in accordance with the will.[134]
3. Court order – a trust created by a court order is seldom a unilateral act but rather a consequence of litigation.[135] The courts use trusts in the settlement of marital disputes, claims for compensation and safeguarding the interests of minors.[136]

2 3 4 3 Duration of trusts

The rule against perpetuity is an English law concept.[137] This rule limits the duration for conditions or restrictions which are permitted to be placed on the property.[138] This rule prevents an individual from adding criteria to a deed that would affect ownership of the property after the individual has died. This is often referred to as *mortmain* or "the dead hand", and it cannot be extended beyond 21 years. This rule was not adopted in South Africa. As a result, there is no limitation on the duration of the lifespan of a trust.[139]

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[130] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1110.
[131] Geach & Yeats *Trusts Law and Practice* 14.
[132] Cameron, De Waal & Solomon *Honoré Law of Trusts* 138.
[133] Honiball & Oliver *The Taxation of Trusts in South Africa* 39.
[134] 39.
[135] *Friedman and Others NNO v CIR: In re Phillip Frame Will Trust v CIR* 1991 2 SA 340 (W).
[136] E Cameron "Constructive Trusts in South African Law: The Legacy Refused" (1999) *ELR* 341; *Dube NP v Road Accident Fund* 2014 1 SA 550 (GSJ).
[137] Cameron, De Waal & Solomon *Honoré Law of Trusts* 601.
[138] 601.
[139] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1111-1112.

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2 3 4 4 Requirements of a trust

In order to establish a valid trust in South Africa, the following requirements must be met:[140]

1. The founder must intend to create a trust.[141]
2. The founder must show intention in a manner that establishes an obligation with regard to implementing the intention. A valid will, contract, court order or statute can create a legal obligation.[142]
3. The trust property must be identified with reasonable certainty.[143]
4. The trust object must be defined with reasonable certainty. The trust object can be personal or impersonal.[144]
5. The trust object must be lawful.[145]

2 3 4 5 The intention to create a trust

At this stage, it is appropriate to discuss the first requirement further. The intention to create a trust is arguably one of the most important requirements in the formation process. If not properly complied with, it can have far-reaching consequences. Generally speaking, if the intention of either party to an agreement is lacking, the question arises whether the agreement or arrangement may be something other than what is being portrayed by the shape or formulation thereof.[146] This is known as a sham or simulation.[147] This is also applicable in the trust context. This should, however, be distinguished from the abuse of the trust structure.[148] Each of the aforementioned has different criteria and outcomes.[149]

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[140] Cameron, De Waal & Solomon *Honoré Law of Trusts* 601; De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1111-1112; Du Toit *South African Trust Law* 179.
[141] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1113.
[142] 1114.
[143] *Deedat v The Master* 1995 2 SA 377(C).
[144] *Braun v Blann and Botha NNO and Another* 1984 2 SA 850(A); *Morley v Standard Bank Trustees Department* 1970 4 SA 299.
[145] *Minister of Education vs Syfrets Trust Ltd* 2006 4 SA 205 (C); *Petersen and Another NNO v Claassen* 2006 5 SA 191 (C).
[146] *Zandberg v Van Zyl* 1910 AD 302.
[147] BS Smith "Sham trusts in South Africa" (2019) *SALJ* 555.
[148] 555.
[149] De Waal (2012) *TRJC& IPL* 1081.

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2 3 4 6 The sham trust

In *Commissioner for the South African Revenue Service v NWK Ltd* ("*NWK*"),[150] the court held that "mere production of agreements does not prove that the parties genuinely intended them to have the effect they appear to have". The paramount question is rather whether the agreement is a true reflection of the parties' true intention. Or, in other words, did they intend to give effect to the agreement as it is presented to the outside world, in the current form and tenor? If not so, effect should be given to the true nature or form of the transaction, which the parties attempted to cloak or disguise in something it is not.[151]

In *Hippo Quarries (Tvl) (Pty) Ltd v Eardley*,[152] the court held that there is a difference between motive, purpose and intention.

> "If the purpose of the parties is unlawful, immoral or against public policy, the transaction will be ineffectual even if the intention to cede is genuine. Conversely, if their intention to cede is not genuine because the real purpose of the parties is something other than cession, their ostensible transaction will likewise be ineffectual. That is because the law disregards simulation".[153]

In determining whether a transaction is simulated, the following two principles should be considered:

1. There is nothing wrong in arranging a person's affairs in such a way that it minimises liability or maximises some advantage.[154]
2. The court "will not be deceived by the form of a transaction: it will rend aside the veil in which the transaction is wrapped and examine its true nature and substance".[155]

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[150] 2011 2 SA 67 (SCA).

[151] *Roshcon (Pty) Limited v Anchor Auto Body Builders CC* 2014 2 All SA 654 (SCA); *Sasol Oil Proprietary Limited v Commissioner for the South African Revenue Service* 2019 1 All SA 106 (SCA).

[152] 1992 SA 867 (A).

[153] *Hippo Quarries (Tvl) (Pty) Ltd v Eardley* 1992 SA 867.

[154] *Dadoo Ltd v Krugersdorp Municipal Council* 1920 AD 530; *CIR v Sunnyside Centre (Pty) Ltd* 1996 58 SATC 319; *Michau v Maize Board* 2003 6 SA 459 (SCA).

[155] *Kilburn v Estate Kilburn* 1931 AD 501; *Erf 3183/1 Ladysmith (Pty) Ltd v Commissioner for Inland Revenue* 1996 3 SA 942 (SCA); *Maize Board v Hart* 2006 SCA 4 (RSA).

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In *Erf 3183/1 Ladysmith (Pty) Ltd v Commissioner for Inland Revenue*,[156] the court held that the aforementioned principles are not mutually exclusive.

In *Zandberg v Van Zyl*,[157] the court held that the real intention of the parties must be established, which differs from the simulated intention. This enquiry is fact-based and will depend on the circumstances of each case.[158]

In *Roshcon (Pty) Limited v Anchor Auto Body Builders CC*,[159] the court explained that there should be an examination of the commercial sense of the transaction. In other words, the real substance or purpose. This would mean that just because the parties comply with the terms of an agreement, it does not necessarily mean that it is not a simulation. If the agreement aims to achieve an object, which will enable a party to circumvent a peremptory rule, it will be regarded as a simulation. The reason is that such an agreement has no real commercial sense. The court further held that the former is merely one of the factors that will be taken into account. Other factors, such as any unusual features of the transaction, the manner in which the parties intend to implement it and surrounding circumstances, will also be considered. The determination should rather establish whether the intention of the parties is genuine. The court confirmed the requirements in *Commissioner for the South African Revenue Service v Bosch* ("*Bosch*").[160] The court further emphasised that for a transaction to be simulated, it must contain a component of disguise or dishonesty. Therefore, the motive or purpose of the parties is irrelevant.[161] The courts recently confirmed the above-mentioned.[162]

If the former is applied in the trust context, if a trust is created by the founder, who does not intend to form a trust but pretends that he does, no real trust will come into existence.[163] Instead, the trust formed will be a sham.[164] The reason for this is that the intention requirement was lacking.[165] In such a case, it is possible that the founder actually intended to form some other legal structure or attempted to derive some

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156 1996 3 SA 942 (SCA).
157 1910 AD 302 at 309.
158 *Customs and Excise v Randles, Brothers & Hudson Ltd* 1941 33 SATC 48.
159 *Roshcon (Pty) Limited v Anchor Auto Body Builders CC* 2014 2 All SA 654 (SCA).
160 2015 1 All SA 1 (SCA).
161 Para 40.
162 *Sasol Oil Proprietary Limited v Commissioner for the South African Revenue Service* 2019 1 All SA 106 (SCA).
163 De Waal (2012) *TRJC& IPL* 1082.
164 1082-1083.
165 BS Smith "Sham trusts in South Africa" (2019) *SALJ* 560.

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illegitimate advantage from using the name of the trust.[166] Whichever the case, the sham trust will not be able to enjoy any of the benefits associated with the trust institution. The courts will also disregard the trust structure if called upon to do so.[167]

2 3 5 Administration of a trust

The administration of a trust is complex and extensive.[168] In this section, the crucial aspects of trust administration are highlighted. Three general principles form the basis of trust administration, namely that the trustee must give effect to the trust instrument; a trustee must carry out his duties and powers with the necessary care, diligence and skill; and a trustee must, at all times, exercise independent discretion.[169] A trustee will only be able to carry out the aforementioned administrative duties once written authorisation has been received from the Master.[170] The affairs of a trust are not entirely a private matter – the TPCA introduced various oversight and publicity requirements.[171] The Master acts in a supervisory capacity, and the powers of the Master conferred by the TPCA include but are not limited to accountability by the trustees and an investigative capacity by the Master.[172] Furthermore, a copy of the trust instrument is required by the Master before the trustees can act with the trust property.[173] The Master must be informed of any amendments thereto.[174] These documents are open to inspection by any individual that can show sufficient interest – this is subject to the discretion of the Master.[175]

2 3 5 1 The duties of the trustees

The trustees are required to safeguard any and all records and documents relating to the trust affairs.[176] As previously stated, in the case of an ownership trust, the trustees

[166] De Waal "The abuse of the (2012) 76 *TRJC& IPL* 1082-1083.
[167] HV Vorster "Sham, alter ego and public policy in South Africa" (2019) 26 *T&T* 24.
[168] De Waal "Trust and fiduciary mechanisms" in *Encyclopaedia of Law* 1122.
[169] Cameron, De Waal & Solomon *Honoré Law of Trusts* 265.
[170] Section 6(1) of the TPCA.
[171] Section 16.
[172] Cameron, De Waal & Solomon *Honoré Law of Trusts* 331-333.
[173] Section 4(1) of the TPCA.
[174] Section 4(2).
[175] Section 18.
[176] Section 17(1). *Doyle v Board of Executors* 1999 2 SA 805 (C).

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are the owners of the trust property in their official capacity.[177] However, this is and should be kept separate from their personal estate. This means that trust property falls outside the reach of the creditors of the trustees.[178] The TPCA echoes this duty and contains extensive directions in this regard. This includes that trust money must be deposited into a separate bank account trust property must be clearly indicated in the bookkeeping, register trust property as such and identify investments as a trust account.[179] Notwithstanding the aforementioned duties, depending on the trust instrument, the trustees must perform additional duties, which may include collecting trust debts, investing trust funds, avoiding conflict of interest, acting impartially, making distributions and making disclosures.[180]

2 3 5 2 The powers of the trustees

The powers commonly granted to trustees by the trust instrument include the power to sell, exchange, mortgage, stand surety, borrow or let trust property.[181] Subject to the trust instrument, if required, the trustees can delegate some or all of these powers, but a total abdication is not permitted.[182]

2 3 5 3 Conduct of the trustees

According to the TPCA, the standard of conduct expected of a trustee is that which can be reasonably expected from a person who manages the affairs of another.[183] Furthermore, trustees are required to act jointly, and the minimum number or quorum of trustees in office must be adhered to.[184] All conduct must fall within the scope of the trust instrument. Failure to do so would leave the trustees personally liable.[185] Any

[177] Olivier et al *Trust Law and Practice* 13.
[178] Cameron, De Waal & Solomon *Honoré Law of Trusts* 292.
[179] Sections 10, 11 and 11(1)(a) of the TPCA.
[180] Cameron, De Waal & Solomon *Honoré Law of Trusts* 270.
[181] 270.
[182] *Hoosen and Others NNO v Deedat* 1999 4 SA 425 (SCA).
[183] F du Toit "Co-trusteeship and the joint-action rule in South African trust law" (2013) *TLI* 18.
[184] 18. *Coetzee v Peet Smith Trust* 2003 5 SA 674 (T); *Thorpe v Trittenwein* 2007 2 SA 172 (SCA); *Investec Bank Ltd v Adriaanse and Others NNO* 2014 1 SA 84 (GNP); *Nieuwoudt and Another NNO v Vrystaat* Mielies (Edms) Bpk 2004 3 SA 486 (SCA); *Land and Agricultural Development Bank of South Africa v Parker* 2005 2 SA 77 (SCA).
[185] MJ de Waal "The liability of co-trustees for breach of trust" (1999) 10 *Stell LR* 21-35.

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attempt or provision that exempts or indemnifies a trustee from breach of trust would be void.[186] A trustee is entitled to reasonable remuneration for services rendered.[187]

2 3 5 4 Investments by trusts

There is no magic formula for good investments. This is also the case for investments by trusts. The trustees are guided by the duties and powers contained in the trust deed. The general duties will apply in so far as the trust deed is silent on the matter. In exercising their investment discretion, they must at all times comply with the terms of the trust. In addition, the statutory duty of care is also applicable to investments.[188]

2 3 5 5 The conservative approach

The traditional view was that trustees should be conservative when dealing with trust property. To this extent, the courts held that trustees should avoid any risk when making investments on behalf of the trust.[189] This meant that trustees' discretion was severely restricted with regard to their investment choices. In addition, the court held that the trustees should act prudently and carefully, which is in contrast to absolute owners who can invest anywhere. Furthermore, such investments must be made with diligence and skill. Therefore, only a limited list of investments was regarded as appropriate for trust funds.[190] This conclusion was derived from the high standard of care imposed upon trustees.[191] In determining whether the trustees complied with the former, all the facts and circumstances of the specific case must be examined.[192] In some instances, the court was willing to deviate from this rule but only subject to certain conditions.[193]

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[186] Section 9(2) of the TPCA.
[187] Section 22.
[188] Section 9(1).
[189] *Sackville v Nourse* 1925 AD 520.
[190] *Jonsson v Estate Jonsson* 1945 NPD 66, 70.
[191] *Peffers NO & Another v Attorneys, Notaries and Conveyancers Fidelity Guarantee Fund Board of Control* 1965 2 SA 53 (C).
[192] *Colonial Banking and Trust Co Ltd v Estate Hughes* 1932 AD 1, 15-16.
[193] *Ex parte van Hasselt* 1965 3 SA 553 (W).

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2 3 5 6 The modern approach

In recent years, the courts increasingly adopted a more liberal approach to trust investments. In *Administrators, Estate Richards v Nichol*,[194] the court held that due to the effect of inflation on money, it is more often necessary to invest in real assets in order to preserve the trust fund's value in real terms. This is especially true for trusts, which are intended to exist for a long time or in perpetuity. The court further explained that what is regarded as a prudent or appropriate investment now may very well change in the future.[195] For this reason, low-risk investments were adequate when inflation was non-existent but insufficient currently. Therefore, there is no point in imposing arbitrary limits for select asset classes.[196] Only the trustees will be able to judge what is the most suitable investment strategy, depending on the circumstances and objectives of the trust. Neither the court nor the Master is in a position to make that determination.[197]

The consequence of the former is that there are no hard and fast rules for trust investments, just that the trustees must follow the stipulations in the trust deed and do so with the necessary standard of care. Besides these requirements, the trustees are free to invest the trust fund in whichever way they see fit, keeping in mind the interests of both income and capital beneficiaries.

2 4 The United Kingdom

The trust is an English law phenomenon; some have described it as the best invention of English jurisprudence.[198] The trust concept emerged from legal practice as a way to address a societal problem. The origin is said to either be during the times of the Crusades or the Franciscan monks.[199] No one knows exactly. In the UK, the trust law developed over the years through the courts. There has been very limited legislative intervention. Therefore, trust law is largely uncodified but rather consists of the common law.

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[194] 1999 1 SA 551 (SCA).
[195] Para 14.
[196] Para 19.
[197] Para 23.
[198] Hudson *Equity and Trusts* 12.
[199] 12.

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2 4 1 The parties to a trust

2 4 1 1 The settlor

In the UK, the person who forms the trust is known as the settlor or founder.[200] There are no qualifications to be a settlor.[201] The only requirement is that the person must have the legal capacity to act.[202] This will typically refer to any person over the age of 18 that is of sound mind. There can be any number of settlors; however, in practice, there are seldom more than two.[203] In such cases, they are referred to as joint settlors. The capacity of the settlor can be held by a private person or corporate entity.[204] The role of the settlor is to create the trust deed and transfer the property, which will be held in trust. The trust deed is the written document containing the trust's powers, duties, responsibilities and conditions.[205] The settlor also appoints the trustees and determines who should benefit under the trust.[206] The settlor is permitted to also be one of the trustees and/or one of the beneficiaries.[207] The only restriction is that the settlor is not allowed to be the sole trustee and sole beneficiary.[208] Such construction will go against the fundamental idea of a trust. In other words, in the latter example, the settlor will remain the absolute owner of the property. After a valid trust is established, the role of the settlor ceases to exist.[209] A settlor can reserve certain powers for himself. The extent and form of these powers are flexible up to a certain point, for example, the power to appoint or remove trustees.[210] Such powers will be protected by law. If the powers reach too far, the courts will set them aside. Under UK law, there are no limitations on the types of property that can be held on trust.[211] Depending on the property type, certain formalities may be required for the transfer to be recognised.

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[200] 39.
[201] Garton *Moffat's Trusts Law: Text and Materials* 4.
[202] 4.
[203] Hudson *Equity and Trusts* 109.
[204] Garton *Moffat's Trusts Law: Text and Materials* 151.
[205] Hudson *Equity and Trusts* 40.
[206] Hayton *Fundamental Principles of Law* 129.
[207] 129.
[208] Hudson *Equity and Trusts* 41.
[209] Garton *Moffat's Trusts Law: Text and Materials* 133.
[210] Hayton *Fundamental Principles of Law* 130.
[211] Garton *Moffat's Trusts Law: Text and Materials* 5.

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2 4 1 2 The trustee

The trustee can be described as the person who manages the trust.[212] The function or office of trusteeship is a fiduciary relationship.[213] Conventionally, it has been described as an onerous role due to the great responsibility and obligation it carries.[214] The role of the trustees is to control, administer and protect the trust property, not for themselves, but for the benefit of the beneficiaries or specified purpose.[215] The trustees, in their official capacity, hold the legal title to the trust property.[216] It is possible that a trustee can also be a beneficiary under the trust.[217] The trustees must act in accordance with the trust deed and the settlor's wishes.[218] In addition to the trust deed, extensive trusteeship duties and powers are contained in legislation in the absence of express provision by the settlor.[219] The effect is an impressive barrage of rules ensuring that trustees cannot abuse with impunity their position as nominal owners, even though their powers of management may be very wide.[220]

The capacity of trusteeship can be held by a natural or juristic person as long as such person has the capacity to hold property.[221] There are no formal requirements or prescribed number of trustees, but under certain circumstances, statute restricts it to four trustees.[222] For practical considerations and proper management, there is seldom only one trustee.[223]

Depending on the nature of the trust, the settlor may select trustees from different groups of people. One can typically divide the types of trustees into the following categories:

1. Non-professional: These trustees are mostly appointed as family members or friends of the settlor. They do not necessarily have any experience or special skills in trust administration but are regarded as trustworthy by the settlor. They

[212] Hudson *Equity and Trusts* 39.
[213] 39.
[214] 39.
[215] Hayton *Fundamental Principles of Law* 130.
[216] 130.
[217] Garton *Moffat's Trusts Law: Text and Materials* 402.
[218] Hudson *Equity and Trusts* 39.
[219] 39
[220] Garton *Moffat's Trusts Law: Text and Materials* 402.
[221] Hayton *Fundamental Principles of Law* 141.
[222] Section 34(1) of the 1925 TA.
[223] Hudson *Equity and Trusts* 42.

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typically oblige due to a sense of moral responsibility. This can stem from, for example, a promise that was made to the settlor.[224]

2. Professional: Often, people with professional qualifications, such as attorneys or accountants, are appointed as trustees. It can be on a voluntary basis or for remuneration. It can be someone with a relationship with the settlor or someone completely independent and objective.[225]
3. Corporate trustees: This can take the form of specialist trust companies or trust departments in banks and insurance firms. They usually render professional services for a fee. There are specific requirements to adhere to before one can offer corporate trustee services.[226]
4. Public trustee: Initially, the office of the public trustee was regarded as the safest and most qualified person to appoint as a trustee. In recent years, the number of trusts under administration by the public trustee has diminished significantly. Currently, it is reserved as an option of last resort.[227] In other words, if there is no one else able or willing to perform the functions of a trustee.

In addition, the UK law makes provision for the office of trusteeship to be divided further into custodian trustees and managing trustees.[228] In such construction, the custodian trustee holds the trust property and related documents of title thereto, while the active management and exercise of all powers and discretions rest with managing trustees.[229] The requirements for a custodian trustee and the relationship between these types of trustees are set out comprehensively in the statute.[230] This division of functions can have significant advantages. The most noteworthy benefits include improved security, transparency, and accountability.[231] Moreover, it is convenient from a practical and cost-efficiency point of view. The reason for the aforementioned is simple. It removes the need to transfer the legal title of the trust property in the case

[224] Garton *Moffat's Trusts Law: Text and Materials* 402.
[225] 402-403.
[226] 404.
[227] 406.
[228] Hayton *Fundamental Principles of Law* 141.
[229] 141.
[230] Section 4 of the Public Trustee Act of 1906.
[231] Garton *Moffat's Trusts Law: Text and Materials* 406.

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that a trustee resigns because the property is vested in the custodian trustee; it has no effect on whether a management trustee vacates his office.[232]

Even though it is possible to use this division of functions in most trust types, it is seldom encountered in the context of private family trusts.[233] However, applying this split in commercial applications[234] such as pension funds and unit trusts is commonplace.

Depending on the circumstances, a trustee can be appointed by the settlor, trustees, beneficiaries, the court, or any person with sufficient interest in the trust.[235] Even though the settlor will appoint the initial trustees, it may subsequently be necessary to appoint new trustees at a later stage.[236] In such a case, the trust deed may set out the process to be followed for the appointment of the trustee.[237] Where the trust deed is silent on the matter, the requirements of the Trustees Act of 1925 ("1925 TA") will be followed.

The only formal requirement is that the appointment of trustees must be in writing.[238] Furthermore, it is necessary for the nominated trustee to accept the nomination explicitly.[239] This can take the form of signing the trust deed or a letter to this extent. No person is under any legal obligation to accept a nomination for trustee and may therefore refuse.[240] In addition, it is permittable that one accepts the nomination subject to certain conditions.[241] For example, limiting liability.

2 4 1 3 The beneficiary

Arguably, the most important party to the trust is the beneficiary. The beneficiary is the person or group set to benefit under the trust.[242] The beneficiaries may be fixed, or the trustees may have the discretion to elect beneficiaries per the settlors' conditions and guidelines.[243] The settlor can identify the selection criteria, such as their relationship

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[232] 406.
[233] 407-408.
[234] 407-408.
[235] Sections 36(1) and 41 of the 1925 TA.
[236] Hudson *Equity and Trusts* 45.
[237] 45.
[238] Garton *Moffat's Trusts Law: Text and Materials* 408.
[239] 408.
[240] Hudson *Equity and Trusts* 45.
[241] 45.
[242] Hayton *Fundamental Principles of Law* 164.
[243] 164.

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to the settlor, from a specified class of people or to achieve a specific objective or purpose.[244] Under UK law, there are no limitations or requirements for beneficiaries.

It is a core principle that a trust must have an ascertainable beneficiary or beneficiaries to be valid.[245] The reasoning behind this principle stems from the idea that there must always be an identifiable beneficiary in whose favour the court can exercise the trust.[246] Furthermore, if there is no beneficiary, there is no one who can keep the trustees in check or alert the court if intervention is necessary.[247] Therefore, it is paramount for the proper administration of a trust.

Linked to the above, a trust for an abstract purpose will be void under UK law.[248] Determining whether a trust is regarded as a people's trust or a purpose trust has been extensively considered by the courts.[249] This has led to conflicting and sometimes obscure results. The basic test is whether a beneficiary has a proprietary right to the trust property.[250] Therefore, beneficiaries who are indirectly benefited will not suffice. The justification for this rule hinges on the risk of abuse and maladministration by the trustees. The only exception to the former rule is charitable trusts.

Depending on the trust type and subject to the trust deed, the nature and scope of beneficiaries' rights may differ.[251] The beneficiaries will always have the right to compel the trustees to execute the trust in terms of the trust deed.[252] As a general rule, beneficiaries have a proprietary right in the trust property.[253] This equitable interest is, therefore, a real right. Another way to put it is to say that the beneficiaries own the beneficial interest in the trust property. This means that beneficiaries have both common-law remedies and equitable remedies available to protect their interest in the trust property. The applicability of the aforementioned rule becomes blurred in the case of discretionary trusts. There are currently differing views on the subject. The only consensus seems to be that it largely depends on the exact wording of the trust

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[244] Hudson *Equity and Trusts* 175.
[245] 175.
[246] *Morice v Bishop of Durham (1805) 10 Ves* 522, 539.
[247] 539.
[248] *Leahy v Attorney-General for NSW* 1959 AC 457.
[249] Hudson *Equity and Trusts* 170.
[250] 184.
[251] Garton *Moffat's Trusts Law: Text and Materials* 234.
[252] 234.
[253] Hudson *Equity and Trusts* 165.

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deed.[254] In addition, the beneficiaries have a personal right against the trustees if a breach of trust should occur.[255]

Moreover, in broad terms, beneficiaries can be classified as income beneficiaries or capital beneficiaries.[256] It is also possible for a beneficiary to be both. Income beneficiaries have a claim for payment from the trust income,[257] while capital beneficiaries have a claim to the trust capital. The trust deed will contain the conditions, frequency and other criteria for the disbursements of trust funds.[258] The former will depend on whether the beneficiary has a vested or contingent right to the trust property. A fixed or vested right is immediately enforceable.[259] Because it is fixed, the interest in the trust property can be attached in the case of insolvency. This interest will also form part of the beneficiary's estate. Conversely, a contingent right is subject to a specific event or condition that has to be met. In the latter case, the beneficiary only has a hope of receiving the benefit. Vesting will only take place when the event occurs or if the condition is satisfied.

2 4 1 4 The protector and enforcer

Besides those parties discussed above, some jurisdictions allow for two additional capacities. Namely: the protector and enforcer. The roles of the aforementioned parties were discussed in paragraph 2 3 1 4, and there is no need to repeat it. Under UK law, there is no provision for either protector or enforcer.[260] It is possible that a trust deed may make provision for such an appointment. In such a case, it will have to be seen whether the courts recognise the powers and duties conferred upon those individuals. It will largely depend on the extent of their powers and how the trust deed is drafted. The most likely scenario is that the court regards such parties as a form of trustee. The reason is that the term protector or enforcer has no technical meaning in UK law. Following on the former, there exists no legal definition or ambit of such a function. There is no legislation or case law dealing with this question.

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[254] 165.
[255] 166.
[256] Hayton *Fundamental Principles of Law* 167.
[257] 167.
[258] Garton *Moffat's Trusts Law: Text and Materials* 234.
[259] 235.
[260] 277.

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Notwithstanding the above-mentioned, protectors or enforcers are often encountered in UK trusts. It should be noted that there is no consistent terminology. The functions in question can be referred to as the protector, advisor, appointer, enforcer, guardian, nominator, managing trustee or managing committee.[261] In the UK, protectors are used to safeguard the beneficiaries' interests. This is typically achieved by controlling some of the trustee's functions and ensuring that the settlor's wishes are followed. To this extent, protectors can often veto trustee decisions, appoint trust property, appoint and remove trustees, or determine trustee remuneration. It should be observed in order to be successful, it should not appear that the protector is able to control or hamper the trustees' freedom in managing the trust. If the latter is true, it may have adverse tax consequences.

If one tries to make sense of the purpose of a protector in UK law, one may equate the protector with a type of trustee. The argument goes along the following lines: If the protector can veto trustee decisions, this will mean that such a person is acting with equal authority as a trustee. Furthermore, if the protector is able to act on behalf of someone else, it must be in a fiduciary capacity.

Protectors are also encountered where the aim is to create a trust without any beneficiaries with vested proprietary rights.[262] This may be done in an attempt to distance beneficiaries from the trust property while still enjoying the benefits thereof.[263] This application of protectors is, however, in contrast with UK law. The reason is that the former goes against the beneficiary principle.[264]

When the trust is established in another jurisdiction, the court may not recognise the concepts of protector or enforcer or elect to declare the trust invalid. This may give rise to a so-called limping trust.[265] A limping trust is a trust which is recognised in the jurisdiction where it is created but not recognised under UK law.[266]

For the time being, the question of whether the English law should be changed to formally make provision for protectors remains unanswered. However, some

[261] No More Tax "Protectors of a Trust" (undated) *No More Tax* <https://www.nomoretax.eu/protectors-of-a-trust/> (accessed 15-01-2022).
[262] Frolik (2015) *RPT&ELJ* 268-269.
[263] 269.
[264] Hudson *Equity and Trusts* 918.
[265] 919.
[266] J Niegel "Purposeful trusts and foundations?" (2012) 18 *T&T* 451-462.

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authors believe that the trust law should be developed to this extent,[267] while others remain more conservative.[268]

2 4 2 The legal nature of a trust

In the UK, there exists the notion of split ownership. On the one end is the legal owner of the property, and on the other is the concept of equitable ownership.[269] The latter was developed by the Lord Chancellor's court, which is known as the Court of Equity.[270] This dual system emerged as a result of the deficiencies in the common law[271] and aimed to remedy this problem by introducing a set of separate principles founded on fairness and justice.[272] Following the former, there now exist two distinct, but related legal systems. Each applies in specific circumstances.

The core of the UK trust evolves around this construction discussed above. Without this parallel system, the trust concept would not be possible. The UK trust is not a juristic person, such as a company.[273] This means a trust does not have a separate legal existence but acts through the trustees. Therefore, a trust can be described as an arrangement recognised by law under which one person holds property for the benefit of another.[274] This notion of the separation between control and enjoyment forms the essence of the trust structure.

2 4 2 1 Ownership of trust property

In their official capacity, the trustees are the legal owners of the trust property, and the beneficiaries are the equitable or beneficial owners.[275] The trustees are not entitled to the trust property for their own benefit, but must manage and control it for the benefit of the beneficiaries.[276] As the legal owners, the trustees have all the powers to perform

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267 S Shah "Towards an enforcer principle in English law: A comparative approach" (undated) *Academia* <https://www.academia.edu/30641963/Towards_an_Enforcer_Principle_in_English_Law_A_Comparative_Approach> (accessed 15-01-2022). D Hayton, P Matthews & C Mitchell *Underhill and Hayton Law of Trusts and Trustees* 19 ed (2016) 165-169.
268 Hudson *Equity and Trusts* 918; J Penner *The Law of Trusts* 11 ed (2018) 253-255.
269 JG Riddall *The Law of Trusts* 6 ed (2002) 2.
270 2.
271 2.
272 3.
273 Hayton *Fundamental Principles of Law* 134.
274 Hudson *Equity and Trusts* 43.
275 55.
276 55.

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their duties.[277] All the property must also be held by or be registered in the name of the trustees,[278] and any action instituted or defended on behalf of the trust is done by the trustees.

Furthermore, the trust property must be kept separate from the trustees' private property.[279] The trust property constitutes a separate estate.[280] Therefore, the trust assets are protected from the trustees' creditors.[281] Similarly, the trust's creditors are limited to trust property.[282] Therefore, the private property of trustees and beneficiaries is free from any risk in that regard. However, the same does not apply to beneficiaries' creditors. Those creditors are permitted to attach a beneficiaries' interest in trust property if a default in payment occurs.[283] This is as a result of the nature of the equitable interest. Because it constitutes a real right, it is regarded as an asset and has value. For the same reason, beneficiaries' interest in trust property will form part of their estate.[284] The only exception to the former is where the trust in question is a discretionary trust.

The beneficiaries have a personal right against the trustees to ensure that they execute their responsibilities correctly.[285] If a breach of trust should occur, the beneficiaries have certain remedies at their disposal.[286] Besides the personal right against the trustees, the beneficiaries also have a real right in the trust property.[287] This puts them in a strong position if the trust property is misused. There are extensive remedies for their protection under both the common law and the law of equity.[288] It should be observed that under UK law, the interests of beneficiaries are elevated above everything else.[289] The courts will protect and enforce the latter, even if it goes

[277] 705.
[278] Garton *Moffat's Trusts Law: Text and Materials* 248.
[279] Hayton *Fundamental Principles of Law* 147.
[280] Hudson *Equity and Trusts* 124.
[281] 124.
[282] 124.
[283] 137.
[284] Garton *Moffat's Trusts Law: Text and Materials* 250.
[285] 250.
[286] 251.
[287] 251.
[288] 254.
[289] Hudson *Equity and Trusts* 160.

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against the intention of the settlor.[290] This is in contrast to the USA, where the wishes of the settlor are supreme.[291]

2 4 2 2 Saunders v Vautier

Equitable ownership enables the beneficiaries to direct or instruct the trustees to perform a specific task under certain circumstances.[292] In *Saunders v Vautier* ("*Saunders*"),[293] the court held that if all the beneficiaries are in agreement, and collectively they own 100% of the equitable interest of the property, they can force the trustees to transfer the property to the beneficiaries. The only caveat is that there should be no conditions outstanding under the trust.[294] Therefore, the interest must be vested and not contingent. Another way to describe it is that the beneficiaries must be the absolute owners of the entire equitable interest. If these requirements are satisfied, it means that the beneficiaries can disregard the intention and wishes of the settlor by dissolving the trust prematurely and taking ownership of the property free from the trust or any restrictions.

It is difficult to reconcile the above principle in the context of discretionary trusts. In such a case, the beneficiaries' interests are contingent.[295] Until the trustees exercise their discretion in favour of a beneficiary, no real right exists in the property.[296] Only once vesting has occurred can the beneficiaries enforce their benefit. For the same reason as the former, under discretionary trusts, the interest of beneficiaries cannot be attached by creditors, nor does it form part of their personal estate.[297]

There are varying views regarding the applicability of the *Saunders*[298] principle, where the property in question is subjected to a discretionary trust.[299] Some argue that it is possible to apply the rule under certain conditions, while others believe it cannot.[300]

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[290] 160.
[291] *Brandon v Robinson* (1811) 18 Ves 429cf; *Claflin v Claflin* 20 NE 454 (1889).
[292] Riddall *The Law of Trusts* 3.
[293] (1811) 4 Beav 115.
[294] *Saunders v Vautier* (1811) 4 Beav 115.
[295] Hayton *Fundamental Principles of Law* 55.
[296] 55.
[297] 55.
[298] (1811) 4 Beav 115.
[299] Hudson *Equity and Trusts* 160-161.
[300] 160-161.

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This matter is far from settled and is being debated. The only consensus, for now, is that it depends on the wording of the trust deed.[301]

2 4 3 Types of trusts

In the UK, trusts are classified into different types based on shared characteristics. There is no concrete, predefined list of recognised trusts. As the application of trusts and trust law develops, so does the array of trust types.[302] Therefore, the determination rather depends on factors such as the purpose of the trust, the rights of beneficiaries, the powers of the trustees and the method of formation.[303]

2 4 3 1 Categories of trusts

Under UK law, one can distinguish between two overarching trust types: express and imputed. [304] The former is where the settlor, by means of a conscious act, intentionally creates a trust.[305] Under this option, the trust can take various forms. The latter arises in defined circumstances to address an injustice by applying legal rules and principles.[306] These rules are a combination of statutory intervention and development by the judiciary.

By far, express trusts are the most popular. It is also this trust type on which this study will primarily focus. Imputed trusts will only be briefly explained to provide a complete picture of the trust framework.

2 4 3 2 Express trusts

Express trusts can be subdivided into the following forms:

1. Bare trust:[307] The trustees hold property for one beneficiary. The beneficiary is absolutely entitled to 100% of the property. Or, in other words, the entire equitable interest. There are no conditions or contingencies. The trustees are only there to manage the property. Therefore, the trustees have no other

[301] Riddall *The Law of Trusts* 288.
[302] Hudson *Equity and Trusts* 39.
[303] 39.
[304] Garton *Moffat's Trusts Law: Text and Materials* 11.
[305] 11.
[306] 11.
[307] Hayton *Fundamental Principles of Law* 50.

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obligations or discretion with regard to the trust property. The role of the trustees is also known as nominees.

2. Fixed trust:[308] The trustees hold property for a fixed defined list of beneficiaries. In other words, those who can benefit from the trust are fixed and cannot change. This is usually where the beneficiaries are named in the trust deed. In such a case, the trustees have no discretion in the administration of the trust but should rather execute the trust in terms of the trust deed.
3. Discretionary trust:[309] The settlor grants the trustees discretion in which manner, the extent and to which beneficiaries a distribution is made. The precise ambit of the discretion depends on the trust deed. Such construction is flexible and able to adapt if necessary. Related to this is the power of appointment. If the settlor confers a power of appointment on the trustees and not a discretion, it is also up to the trustee whether a distribution is made at all.
4. Secret trust:[310] In the instance where a settlor wishes to benefit a person, which cannot be named in the declaration, the settlor will enter into an arrangement with a trusted confidant, under which the settlor will name the aforementioned party as the recipient of the property, who will in actual fact hold the property on trust for the undisclosed beneficiary. This is typically achieved by means of a will. There are various forms and deviations of this concept.
5. Accumulation or maintenance trust:[311] The settlor may create a trust to maintain his spouse or children. In such a case, the trustees are required to invest and preserve the trust funds. The trustees are responsible for distributing funds to take care of the beneficiaries' current needs. The trustees may or may not have any discretion in this regard.
6. Trading trust:[312] The trust can be used to conduct a business or enterprise. The trustees are in charge of the day-to-day management and administration of the business. This is an alternative ownership structure to that of companies and partnerships.

[308] Hudson *Equity and Trusts* 45.
[309] Riddall *The Law of Trusts* 283.
[310] Garton *Moffat's Trusts Law: Text and Materials* 164.
[311] Hudson *Equity and Trusts* 46.
[312] Hayton *Fundamental Principles of Law* 67.

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7. Unit trust:[313] The trust form is used to facilitate investment among a group of people. Each member contributes to the trust capital with the aim for it to be invested. The collective funds are then invested as a whole. It is the role of the trustees to manage the investments.
8. Charitable trusts:[314] Trusts are used to benefit a specified purpose or to reach a defined objective. Therefore, it does not benefit people directly but rather applies the trust property in such a way to further the cause.

It is noteworthy that the UK trust law does not allow for the creation of a protective trust.[315] To contextualise, a protective trust can be used to protect assets from:

1. A beneficiary who is unable to manage their finances prudently or who is unable to control their impulses.[316] For example, a person with a substance abuse problem or impulsive behaviour.
2. To prevent the settlor from appearing to have title to the property, which may be attached in insolvency proceedings.[317] In other words, to hide property from the reach of creditors while enjoying the benefit thereof.
3. To prevent the settlor from appearing to be absolutely entitled to trust property, to circumvent tax laws or other regulatory requirements. Otherwise, the settlor may be liable for tax.[318] If the settlor is absolutely entitled to the property, he will be regarded as having all the equitable interest therein.

It is difficult to construct such a trust because a beneficiary, who is absolutely entitled to the trust property, can direct the trustees on how to act with that property.[319] Therefore, the beneficiary will be considered to have all the equitable ownership of the property. In such cases, the courts will not allow a beneficiary to deny proprietary rights in the property.

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[313] Hudson *Equity and Trusts* 164.
[314] Riddall *The Law of Trusts* 283.
[315] Hudson *Equity and Trusts* 166.
[316] 166.
[317] 166.
[318] 166.
[319] *Saunders v Vautier* (1811) 4 Beav 115.

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2 4 3 3 Imputed trusts

Imputed trusts can take the following forms:

1. Constructive trust:[320] Such trust arises by the operation of law. If the facts and circumstances of a case demand it, the court will imply a constructive trust to try and remedy the unconscious conduct. For example, in the instance where property has been stolen, the court will regard that person to hold the property on constructive trust for the rightful owner. The way and context in which the courts use constructive trusts can differ.
2. Resulting trust:[321] This trust form is implied by the courts. It can either be as a consequence of a failed express trust or to restore equality and fairness. For example, if a settlor creates an express trust but omits to specify the beneficiaries or some of the descriptions are not valid, the equitable interest in the trust property, or the portion thereof, will be held on the resulting trust for the benefit of the settlor. Another example is where more than one person contributes to the purchase of the property. The equitable interest of each person, in the proportions of their contributions, will be held on resulting trust for their benefit. Various variations and deviations of resulting trusts are possible.

2 4 4 Method of formation

In the UK, there are various ways to form an express trust. The type of trust will depend on the factors and forms discussed in paragraph 2 3 3. Generally speaking, there are two stages in creating a trust, namely:

1. A valid declaration of trust.[322]
2. Transfer of the legal title in the trust property to the trustees.[323]
3. The exact formal requirements for the trust will depend on the nature of the property and the form in which the declaration is made.[324] Notwithstanding specific formal procedural requirements, the trust must, in any case, satisfy all the requirements for a valid trust, as discussed in paragraph 2 3 4 4 above. From the outset, one can distinguish between two broad categories, namely:

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[320] Riddall *The Law of Trusts* 238.
[321] 238.
[322] Hudson *Equity and Trusts* 211.
[323] *Milroy v Lord* (1862) 4 De GF & J 264.
[324] Garton *Moffat's Trusts Law: Text and Materials* 4.

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a. *Inter vivos* trusts:[325] This is where the settlor creates a trust for beneficiaries during his lifetime. Such declaration can either be in writing or can be made orally. Even though it is permittable to establish a trust verbally, it is not recommended. This is largely for practical and evidentiary reasons. The basis for an *inter vivos* trust is grounded in contract. If the property in question is personal property, which does not fall in one of the categories discussed below, there are no formal requirements for such a trust. In the UK, it is possible for a settlor to declare unilaterally that property is held on trust for some other person. In such a case, no transfer is necessary. [326]

b. Testamentary trust:[327] It is also possible to create a trust in a will. For such trust to be valid, the will must comply with all the formal requirements for a valid and enforceable will.[328] Furthermore, all the terms of the trust must be clearly stipulated in the will.

It is important to note that no trust can be formed over any property if the settlor does not have the propriety interest therein. In other words, the settlor must be the owner of the property before it can be the subject of a trust.[329]

As previously stated, depending on the type of property that will be held in trust, there may be additional requirements to adhere to. The most important is if the property to be transferred is land or an interest in land.[330] In such a case, the statutory requirements must be complied with.[331] If a trust is successfully created over land, the Trusts of Land and Appointment of Trustees Act of 1996 becomes applicable. If the trust consists of other property, it should be delivered to the trustees or their legal title thereto duly noted in the prescribed form or manner specified by law.[332] This may include, for example, cash, movables, shares or intellectual property.

[325] Hudson *Equity and Trusts* 211.
[326] Hayton *Fundamental Principles of Law* 4.
[327] Hudson *Equity and Trusts* 211.
[328] Section 9 of the Wills Act 1837.
[329] *Norman v Federal Commissioner of Taxation* (1963) 109 CLR 9.
[330] Garton *Moffat's Trusts Law: Text and Materials* 137.
[331] Section 53(1)(b) of the Law of Property Act 1925.
[332] Hudson *Equity and Trusts* 211.

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It is noteworthy to observe that once a trust has been validly constituted, it cannot be cancelled or undone.[333] Neither can the settlor retrieve the property for himself. The only exception is if the trust deed makes explicit provision for such power. Such a right of revocation may have adverse and unintended tax consequences. The settlor will be regarded as the owner of that property.[334]

2 4 5 Duration of a trust

Under UK law, no trust is allowed to exist in perpetuity.[335] This means that all equitable interests must vest no later than 21 years from the end of a life that was in existence when the trust was formed.[336] Furthermore, the beneficiary of the said interest and the extent thereof must be ascertainable.[337] This is a policy position, and the underlying principles are as follows: The rule against remoteness of vesting and the rule against inalienability.[338] The former states that all interests of beneficiaries must vest within the perpetuity period. The latter prevents income from being tied up in the trust after the perpetuity timeframe.[339]

After a statutory intervention, the perpetuity period was changed to 80 years.[340] In recent years, this was subsequently amended to 125 years.[341] This was in an attempt to simplify the perpetuity rules. The latter is, however, not applicable to charitable trusts.

2 4 6 Requirements of a trust

Before a valid trust can come into existence, various requirements must be complied with. The requirements are as follows.

1. There must be an intention to create a trust.[342]

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[333] *Paul v Paul* (1882) 20 Ch D 742.
[334] Hudson *Equity and Trusts* 211.
[335] Garton *Moffat's Trusts Law: Text and Materials* 345.
[336] 345.
[337] 345.
[338] Hudson *Equity and Trusts* 211.
[339] 211.
[340] Perpetuities and Accumulations Act 1964.
[341] Section 5(1) of the Perpetuities and Accumulations Act 2009.
[342] Hudson *Equity and Trusts* 76.

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2. There must be certainty as to the property forming the subject matter of the trust.[343]
3. The trust must have beneficiaries.[344]
4. There must be certainty as to the identity of the beneficiaries.[345]
5. There must be certainty as to the share of property each beneficiary is entitled to receive.[346]
6. The correct formalities must be observed.[347]
7. The trust must not infringe the perpetuity and related rules.[348]
8. The object or purpose of the trust must be lawful and not contrary to public policy.[349]

2 4 6 1 The intention to create a trust

Of all the requirements, the first is the most important. If the settlor does not intend to create a trust, no trust will be formed.[350] The courts have held that mere precatory words are not sufficient.[351] Besides the precise wording used, the surrounding facts and circumstances will guide the interpretation[352] even though the settlor did not know he was trying to create a trust.[353] However, in *McPhail v Doulton*,[354] the court held that "a trust should be upheld if there is sufficient practical certainty in its definition for it to be carried out, if necessary with the administrative assistance of the court, according to the expressed intention of the settlor."[355]

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343 76.
344 76.
345 Garton *Moffat's Trusts Law: Text and Materials* 230.
346 230.
347 Hayton *Fundamental Principles of Law* 18.
348 Riddall *The Law of Trusts* 27.
349 Hudson *Equity and Trusts* 93; s 37 of the Matrimonial Causes Act 1973; s 10 of the Provision for Family and Dependants Act 1975; s 426 of the Insolvency Act 1986.
350 Hudson *Equity and Trusts* 93.
351 *Re Hamilton* [1895] 2 Ch 370 374
352 *Comiskey v Bowring-Hanbury* 1905] AC 84
353 *Twinsectra Ltd v Yardley* [2002] 2 All ER 377.
354 [1970] UKHL 1.
355 *McPhail v Doulton* [1970] UKHL 1.

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2 4 6 2 The sham trust

If the settlor establishes a trust in an attempt to portray a certain perception but does not really have the intention to create a trust, the court will give effect to the substance and not the form of the transaction.[356] This occurrence is often encountered in cases where a party attempts to avoid tax liability, circumvent creditors, or conceal actual ownership. The latter is known as a sham.

The sham concept can manifest in a vast array of transactions, including but not limited to trusts.[357] The term sham can be defined as:

> "acts done or documents executed by the parties to the 'sham' which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intended to create".[358]

The court described the enquiry as identifying "the real truth of the matter".[359]

In the construction process, the courts are tasked with identifying the parties' true intentions.[360] This alone is not an easy determination. In order to do the former, the court must first ascertain the intended rights and obligations.[361] Second, the court must categorise the transaction.[362] Suppose the parties have mislabelled the transaction in an attempt to derive different legal consequences from the transaction than the rights and obligations conferred. In that case, the court will disregard the attached label and assign the transaction with the correct label while executing the true rights and obligations.[363]

The normal rules of construction require the court to only regard the objective facts and surrounding circumstances of the case when ascertaining the intention of

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[356] *Ramsay v IRC* [1981] STC 174; *Furniss v Dawson* [1984] 2 WLR 226; *Fitzwilliam v IRC* [1993] STC 502; *McGuckian v IRC* [1997] STC 908; *MacNiven v Westmoreland Investments Ltd* [2001] STC 327; *Barclays Mercantile Business Finance Ltd v Mawson* [2004] UKHL 51.
[357] *Yorkshire Railway Wagon Co. v Maclure:* CA1182; *Re Watson, Kipling and Co*: CHD 1883; *Chase Manhattan Equities Ltd. v Goodman* [1991] BCC 308.
[358] *Snook v London and West Riding Investments Ltd* [1967] 1 All ER 518.
[359] *Re Watson, Kipling and Co*: CHD 1883.
[360] M Conaglen "Sham trusts" (2008) 67 *TCLJ* 176-207.
[361] 178.
[362] 178.
[363] *Street v Mountford* [1985] AC 809. *Antoniades v Villiers* [1988] UKHL 8.

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the parties.[364] The sham doctrine enables the court to also consider other factors, such as the parties' subjective intention, their subsequent conduct, and related considerations.[365]

The sham doctrine goes beyond merely the instance where the intention to create a trust is lacking.[366] However, there is support for this argument that a sham equates to purely a lack of intention.[367] Even though it is true, there can be no trust if the intention requirement is absent or unclear.[368] In the former, there are no objective intentions, but in the sham example, objectively speaking, there may be an intention, but it does not coincide with the subjective intention.

In determining whether a trust is a sham, the court will not merely rely on the literal meaning of the documents but examine the external circumstances as well.[369] It is important that there is an intention or aim to deceive or mislead others.[370] The courts also emphasised this requirement.[371] This is in contrast with earlier judgments.[372] It is, however, unclear whether all the parties should be aware that it is a sham transaction. It may be sufficient for only one of the instigators to have known, even though the rest was left in the dark.

Notwithstanding the former, the court has held that a common intention among all parties is necessary to prove that the transaction is a sham.[373] This requirement stems from the principles relating to the certainty of bilateral transactions. This is also the position in the UK territories.[374] In addition, the court has held that an indifferent attitude may well constitute the necessary intention in the affirmative.[375] This reasoning explains the contradictive findings by some courts.[376] Regardless of the former, some authors contradict this common requirement.[377]

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[364] Conaglen (2008) *TCLJ* 180.
[365] *AG Securities v Vaughn* [1990] UKHL 1 AC 417.
[366] Conaglen (2008) *TCLJ* 181.
[367] J Palmer "Dealing with the popularity of sham trusts" (2007) 81 *NZLR* 81-102.
[368] *Knight v Knight* (1840) 3 Beav 148.
[369] *Hitch v Stone* [2001] BTC 78.
[370] *Midland Bank v Wyatt* [1995] 1 FLR 697.
[371] *Hitch v Stone* [2001] BTC 78.
[372] *Midland Bank PLC vs Wyatt* [1997] 1 BCLC 242.
[373] *Shalson v Russo* [2003] EWHC 1637.
[374] *Grupo Torras SA v Sheikh Fahad Mohammed Al-Sabah* [1999] CLC 1469; *MacKinnon v Regent Trust Co. Ltd* [2005] WTLR 1367.
[375] *Agip (Africa) Ltd v Jackson* [1990] EWCA J1221-1; *Medforth v Blake* [1999] EWCA Civ 1482.
[376] *Midland Bank v Wyatt* [1997] 1 BCLC 242; [1995] 1 FLR 697; *Hitch vs Stone* [2001] BTC 78.
[377] Palmer "Dealing with the popularity of sham trusts" (2007) *NZLR* 87.

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In *Chase Manhattan Equities Ltd. v Goodman*[378] the court has held "it is not necessary for the parties affirmatively to intend to enter into any particular transaction once it is shown that the ostensible transaction was a pretence". However, it may be beneficial if the real intention can be shown. This relates mostly to evidentiary and practical considerations.[379] As a point of departure, there is a presumption that documents are not shams. In order to prove the opposite, the real intended transaction must be shown. Furthermore, the default recourse for the court, when it has found that the document in question is a sham, is to ignore the sham document and proceed based on the true intention.

Moreover, it is possible to declare a portion of a document a sham if the document contains more than one transaction or dividable parts.[380] Closely related is the fact that just because a transaction is artificial, it does not necessarily mean it is a sham.[381] However, it will be one of the factors taken into account.[382] This is especially true if the trust deed contains strange provisions or clauses that confer wide powers upon the settlor.[383] Furthermore, the degree of control of the settlor over the trustees and their decisions, and/or the trust property, gives a strong indication of whether the trust is a sham.[384]

Following the above-mentioned discussion, the sham dogma must be distinguished from rectification. The latter occurs where the parties made a *bona fide* mistake, in contrast to the former, where the parties intentionally attempted to deceive others. There are, however, some authors that are of the opinion that a sham and rectification are the same.[385] In these cases, the courts will disregard the trust and give effect to the true meaning of the parties. This may also mean that the court looks behind the trust or any rights apparently created. Therefore, no rights are conferred

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[378] [1991] BCLC 897.
[379] Conaglen (2008) *TCLJ* 178.
[380] *Hitch v Stone* [2001] BTC 78.
[381] *National Westminster Bank PLC v Jones* CA 24 October 2001.
[382] *W T Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300; *Furniss v Dawson* [1984] 2 WLR 226; *Craven v White* [1989] AC 398.
[383] P Matthews (2007) *TLI* 191-203.
[384] *Rahman v Chase Bank* (CI) [1991] JLR 103; *Minwalla v Minwalla* [2004] EWCA Civ 1589.
[385] Matthews (2007) *TLI* 194.

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on any party under a sham trust. The courts have also demonstrated their willingness to set aside sham trusts.[386] The UK territories also follow this approach.[387]

It is important to note the one that alleges that there is a sham bears the onus to prove that.[388] To this extent, it is paramount to have factual evidence available.[389]

Unlike in other common-law jurisdictions, under UK law, there is no distinction between a sham trust and the abuse of the trust,[390] such as where a trust is used as the alter ego of the settlor. Some authors dispute that the latter example must also be regarded as sham trusts.[391] Both the aforementioned is regarded as sham transactions. Evidently, the consequences are also the same.[392]

Some authors believe that shams can be divided into different categories, for example, sham in law and sham in fact.[393] The sham in law refers to the case where X declares a trust over the property for X, or where someone meant to create an *inter vivos* trust but actually created a will.[394] Following this argument, a sham is where a trust deed creates a trust, but it does not reflect the true terms of the trust.[395] It is submitted that this cannot be correct. Nor is it consistent with the case law on this topic. The former is rather a legal error, where formal requirements are not met. This will result in no valid trust coming into existence. The latter scenario can only be a sham if the intention to deceive or mislead is present.

2 4 7 Administration of a trust

Under UK law, the courts have inherent jurisdiction over the administration of a trust.[396] This includes, but is not limited to, giving direction, assuming control of the trust, judicial review or setting aside decisions. The court will only intervene if it is just and equitable to do so. The court ensures that the trust is administered in accordance with

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[386] *Midland Bank PLC vs Wyatt* [1997] 1 BCLC 242; *Minwalla v Minwalla* [2004] EWCA Civ 1589; *Painter v Hutchison* [2007] EWHC 758.
[387] *Rahman v Chase Bank* (CI) [1991] JLR 103.
[388] *National Westminster Bank PLC v Jones* CA 24 October 2001; *Mikeover v Brady* 21 HLR 513.
[389] Matthews "The sham trust argument" (2007) *TLI* 196.
[390] Hudson *Equity and Trusts* 93.
[391] Palmer (2007) *NZLR* 93.
[392] Conaglen (2008) *TCLJ* 178.
[393] Matthews (2007) *TLI* 196.
[394] 196.
[395] Matthews (2007) *TLI* 196.
[396] Hudson *Equity and Trusts* 301.

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the trust deed and that the interests of the beneficiaries are protected.[397] Therefore, the court's role can be described as an oversight or supervisory position.

As a point of departure, the office of trusteeship can be summarised in the following general principles: good conscience, effective management and fair dealing.[398]

2 4 7 1 Duties of the trustees

Before a trustee may act with the trust property, a valid appointment is necessary.[399] Subsequent to the appointment, the trustee must familiarise themselves with the terms, conditions and history of the management of the trust. [400] Once all formalities have been complied with, all trustees are bound by the obligations under the trust deed.[401] A failure to adhere to any of the terms of the trust deed will constitute a breach of trust.

As discussed previously, the trustees hold the legal title of the trust property, while the beneficiaries have an equitable interest in the trust property.[402] Closely linked is the duty to safeguard trust assets.[403] This can be described as an active duty. Therefore, depending on the type of property, the obligations may differ. The trustees must further ensure that the property is applied in accordance with the trust deed. It is also paramount that the trust property is kept separate from the trustees' private property.[404]

Ordinarily, access to information is restricted to beneficiaries with a proprietary interest in the property.[405] Even in such cases, the information is limited to only what is directly relevant to their interest.[406] Neither do the trustees have to furnish the beneficiaries with reasons for decisions taken.[407] Notwithstanding, consequent to the court's role, the court has a discretion whether or not to order access to information.[408]

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[397] Garton *Moffat's Trusts Law: Text and Materials* 409.
[398] Hudson *Equity and Trusts* 307.
[399] Riddall *The Law of Trusts* 308.
[400] 308.
[401] *Clough v Bond* (1838) 3Cr 490.
[402] Hayton *Fundamental Principles of Law* 15.
[403] Hudson *Equity and Trusts* 315.
[404] Hayton *Fundamental Principles of Law* 15.
[405] *O'Rourke v Darbishire* [1920] AC 581.
[406] *Re Londonderry* [1965] Ch 918.
[407] *Re Londonderry* [1965] Ch 918.
[408] *Schmidt v Rosewood Trust Ltd* [2003] 2 WLR 1442.

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This will only be granted if the court regards it as appropriate. In most instances, the court will not exercise its discretion in favour of the applicant where it concerns confidential information.[409] Regardless, the trustees are obliged to give beneficiaries' accounts relating to the trust's affairs.[410]

One of the overarching duties is the duty to act with reasonable care. This means to act as a prudent person of business would have acted if acting on behalf of another.[411] This was later expanded to make provision for taking reasonable risks.[412] The introduction of the statutory duty of care did away with the prudence requirement imposed by case law. Instead, it is based on reasonableness.[413] The standard is adaptable to the circumstances and incorporates a subjective test.

Additional duties typically include:

1. duties relating to trust expenses;[414]
2. the duty to act even-handedly and impartially between beneficiaries;[415]
3. duties of investment;[416]
4. duty to distribute the trust property correctly;[417]
5. the duty to avoid conflicts of interest;[418]
6. the duty to preserve the confidence of the beneficiaries;[419]
7. the duty to comply and act in terms of the trust deed;[420] and
8. the duty to exercise their discretion and powers in an informed manner.[421]

2 4 7 2 Powers of the trustees

In broad terms, the powers usually conferred on trustees include:

1. the power to give receipt;

409 *Re Londonderry* [1965] Ch 918.
410 *Springett v Dashwood* (1860) 2 Giff 521; *Newton v Askew* (1848) 11 Beav 145.
411 *Learoyd v Whitele* (1887) 12 App Cas 727.
412 *Bartlett v Barclays Bank* [1980] Ch 515.
413 Section 1 of the 2000 TA.
414 *HMRC v Peter Clay Discretionary Trust* [2009] 2 WLR 1353.
415 *Nestle v National Westminster Bankplc* [1993] 1 WLR 1260; *Re Lepine* [1892] 1 Ch 210, 219.
416 *Cowan v Scargill* [1985] Ch 270. Speight v Gaunt (1883) 9 App Cas 1.
417 *Re Smith* (1902) 71 LJ Ch 411.
418 *Tito v Waddell* (No 2) [1977] 3 All ER 129; *Re Thomps Settlement* [1985] 2 All ER 720; *Kelly v Cooper* [1993] AC 205.
419 *Bristol & West Building Society v Mothew* [1998] Ch 1.
420 *Clough v Bond* (1838) 3Cr 490.
421 *Pitt v Holt, Futter v Futter* [2011] EWCA Civ 197.

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2. the power to compromise;
3. the power to delegate; and
4. the power to maintain and advance.[422]

2 4 7 3 Conduct of the trustees

Furthermore, the general rule is that all trustees must act jointly.[423] The trust deed may prescribe a different minimum quorum. In such a case, the trust deed will prevail. The statute also contains exceptions, under which circumstances it is acceptable to deviate from this rule.[424] Moreover, traditionally trustees are not allowed to delegate their powers.[425] Nevertheless, after statutory intervention, it is permissible in limited circumstances. The former may have an impact on the liability of trustees.

In some cases, the trustees will be responsible as a collective, and in other circumstances, they will only be liable for their own conduct or the lack thereof. [426] It is possible for trustees to limit or exclude their liability. Such a clause will only be valid if the applicability is restricted to negligence and/or gross negligence.[427] No attempt to indemnify trustees for dishonesty or fraudulent conduct is permitted. In addition, trustees may be remunerated for their services, regardless of the level of skill required.[428] The only caveat is that it must be reasonable in the circumstances.[429] Similarly, the trustees are entitled to be reimbursed for trust-related expenses and to be indemnified for contractual obligations.[430] The latter is only applicable if the trustees comply with the terms and conditions of the trust deed.[431]

[422] Hudson *Equity and Trusts* 418.
[423] 427.
[424] Section 11 of the 2000 TA.
[425] *Revenue & Customs Commissioners v Trustees of the Peter Clay Discretionary Trust* [2008] 2 WLR 1052, 1062.
[426] Hudson *Equity and Trusts* 427.
[427] Garton *Moffat's Trusts Law: Text and Materials* 416.
[428] Sections 28(2), 29(3) and 32 of the 2000 TA.
[429] Section 28.
[430] Section 31(1). *Rowley v Ginnever* [1897] 2 Ch 503; *Travis v Illingworth* [1968] WN 206.
[431] *Dowse v Gorton* [1891] AC 190; *Vacuum Oil Co (Pty) Ltd v Wiltshire* (1945) 72 CLR 319.

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2 4 8 Investments by trusts

The point of departure for the investment powers and duties of the trustees is always the specific trust deed.[432] If the trust deed is silent on the matter, or to the extent that it is, the provisions of the Trustee Act of 2000 ("2000 TA") will apply.

The 2000 TA confers a wide general power of investment on the trustees so that they are permitted to make any type of investment, as they would have been able to do if they were absolute owners of the trust property.[433] This is in contrast with earlier years when the trustees were obliged to adhere to the requirements and prescribed investment forms, as stipulated by statute.[434]

2 4 8 1 Trustee discretion

The introduction of the statutory duty of care moved away from the requirement to be prudent, as set out in case law.[435] In accordance with the prudency requirement, a greater focus was placed on protecting and maintaining the trust fund than maximising growth. During this time, it was believed that a gradual growth in value was the most suitable approach. This is in contrast with the modern view of perpetual growth.

Instead, the test is reasonableness.[436] This shift means that the trustees will have a wider choice of investments from which they can choose. Before making any investment, the trustees must consider the standard investment criteria.[437] Therefore, the investments must be suitable for the trust, and the portfolio of investments must be sufficiently diversified.[438] Both of these requirements revolve around limiting the level of risk to which the trust fund is exposed. In determining whether an investment is suitable, factors such as the nature of the trust, the purpose of the investment and the duration of the investment must be considered.

Diversification refers to different types of investments, in different forms, in different sectors of the economy and in different markets.[439] Once again, the degree of diversification will depend on the specific circumstances of the trust. This is in line

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[432] Hudson *Equity and Trusts* 418.
[433] Section 3(1) of the 2000 TA.
[434] The Trustee Investment Act 1961
[435] See paragraph 2 4 7 Administration of a trust.
[436] Section 1 of the 2000 TA.
[437] Section 4(1).
[438] Section 4(2).
[439] Hudson *Equity and Trusts* 393.

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with modern portfolio theory.[440] The idea behind the latter is that a diverse portfolio will perform well in different conditions. It also mitigates the amount of risk taken. The reasoning is that the gains of one investment will offset the losses of another.

2 4 8 2 Investment requirements

Furthermore, there is an obligation on the trustees to seek proper advice before making any investment on behalf of the trust or if contemplating whether to vary existing investments.[441] A professional advisor, which is consulted under normal commercial terms, will constitute proper advice, but whether other forms of advice will satisfy the standard will depend on the circumstances.[442] The trustees are not bound by the advice and may well elect not to follow it.[443]

Moreover, the trustees have a duty to make investments in the best interests of the beneficiaries.[444] The courts interpret this requirement to mean the beneficiaries' financial interests.[445] Therefore, other considerations are irrelevant in deciding whether to invest.[446] Similarly, the trustees have a duty to act fairly amid different classes of beneficiaries. This refers to striking a balance between generating income and preserving the trust capital.[447]

2 5 Belgium

France and the Netherlands, both civil law countries, greatly influenced the development of Belgium law. For this reason, the trust concept is unknown to Belgium and it is not possible to establish a trust under Belgium's domestic law.[448] Both France and the Netherlands have also elected not to subsume the trust structure into their legal system but rather decided to create their own form of a "trust-like entity". The latter is not the case with Belgium, but there are, however, a number of so-called "trust-like entities" recognised under Belgium law, such as a private foundation, a civil

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[440] *Nestle v National Westminster Bank Plc* [2000] WTLR 795.
[441] Section 5 of the 2000 TA.
[442] Hudson *Equity and Trusts* 393.
[443] *Cowan v Scargill* [1985] Ch 270, 289.
[444] Riddall *The Law of Trusts* 340.
[445] *Cowan v Scargill* [1985] Ch 270, 289.
[446] Hudson *Equity and Trusts* 401.
[447] *Nestle v National Westminster Bank plc* [2000] WTLR 795.
[448] J-M Tirard *The Global Guide to Trusts: A Systematic Analysis of the Legal Regime and Tax Treatment of Trusts in 21 Jurisdictions* (2017) 22.

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society/partnership, *Private Privaks* or *Stichting Administratiekantoor*. In addition, it was proposed to make provision for an entity called the *fiducie*, in the upcoming revised Belgium civil code.[449] This invention was dubbed the Belgium trust. The exact details surrounding the *fiducie* are still unknown, and to what extent it overlaps with the trust remains to be seen. However, this project appears to have been put on hold for now and will subsequently not be included in the new Belgium Civil Code. Even though these entities may share some characteristics of a trust, it should be emphasised that neither one of these "trust-like entities" replaces the trust. There remain vast differences between such entities, some of which are incompatible with a trust's core aspects. It should be noted that a further comparison of trusts and trust-like entities falls outside the scope of this study.

2 5 1 The recognition of foreign trusts in Belgium

Belgium is not a signatory of the Hague Convention on the Law Applicable to Trusts and on their Recognition ("Hague Convention"), nor did they ratify the former.[450] Notwithstanding the aforementioned and the fact that trusts are not known in Belgium's domestic law, foreign trusts are recognised in Belgium[451] as long as the trust is validly created and complies with the law of that jurisdiction.[452] The only caveat is the trust deed must conform to Belgium's forced heirship rules.[453] If that is not the case, the forced heirship rules will trump any provision in the trust deed. However, this only applies to property within or controlled from Belgium.[454] Otherwise, the law where the trust was established will apply.[455] In addition, the provisions of the international regulation on international successions number. 650/2012 of 4 July 2012 may be

[449] Federale Overheidsdienst "Hervorming Burgerlijk Wetboek" <https://justitie.belgium.be/nl/bwcc (accessed 26-04-2023).

[450] The Hague Convention "Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition" (1985) <https://www.hcch.net/en/instruments/conventions/full-text/?cid=59> (accessed 22-01-2022).

Neither South Africa nor the UK are signatories to the Hague Convention. Dince both the aforesaid jurisdictions recognise trusts, there is no need for the Convention's application.

[451] International Bar Association "Belgium International Estate Planning Guide" (2017) *IBANET* <https://www.ibanet.org/internationalestateplanningguides.aspx> (accessed 22-01-2022).

[452] International Bar Association "Belgium International Estate Planning Guide" (2017) *IBANET*.

[453] Civil Court Brussels, 27 November 1947. Civil Court Antwerp, 4 March 1971. Civil Court Brussels, 31 May 1994.

[454] Article 124(3) of the International Private Law Act 2004.

[455] Article 125.

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applicable with regard to the devolution of the assets and the determination of the beneficiaries, regardless of the fact that trusts are generally excluded from the scope of this regulation.

Belgium's private international law governs the recognition of foreign trusts. The International Private Law Act of 16 July 2004 ("IPLA") introduced a legal definition of a trust in Belgian law.[456] This definition encapsulates the fundamental aspects of a trust, namely, the separation between the trust estate and that of the trustees,[457] that the trustees hold the legal title of the trust property[458] and that the trustees have the power and obligation to administer the trust property in accordance with the trust deed.[459]

The provisions in the IPLA are similar to the Hague Convention but much more limited in scope. The settlor can select the applicable law by which the trust will be governed. In the absence of a choice of jurisdiction, or if the selection is invalid, the law of the jurisdiction where the trustees are domiciled will apply.[460] This jurisdiction determines the settlement of the trust, the interpretation, the governance of the trust, the rights and obligations that relate to it, the consequences of the trust, and the termination of the trust.[461]

Belgium courts will only have jurisdiction over the trust and the power to make rulings pertaining to the legal aspects regarding the settlor, trustees and beneficiaries in the instance where the trust is administered in Belgium, the assets in question are situated in Belgium or if the trust deed grants explicit competence to Belgium courts to do so

Furthermore, trusts and other fiduciary entities are subjected to extensive reporting requirements and the provisions of the Cayman tax regime.[462] This is discussed in more detail in subsequent chapters of this study.

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[456] Article 122.
[457] Article 122(1).
[458] Article 122(2).
[459] Article 122(3).
[460] Article 24.
[461] Article 25.
[462] JM Tirard *The Global Guide to Trusts: A Systematic Analysis of the Legal Regime and Tax Treatment of Trusts in 21 Jurisdictions* (2017) 17.

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2 6 Comparison of jurisdictions

As illustrated in this chapter, the trust is no longer exclusively used and praised by the common-law countries but is rapidly spreading to traditional civil law jurisdictions too. The former also led to the development of the international aspect of trusts. To this extent, policies and frameworks are created to regulate and accommodate the aforementioned.

The trust can be described as a malleable entity that is used in a vast range of circumstances. In addition, the application of the trust is constantly expanded to adapt to the changing world. This also means that there are negative uses of trusts.

In South Africa and the UK, the trust concept was developed at different times and adapted to varying degrees to be compatible with the legal system and circumstances. Even though this meant that the trust was not identical in both jurisdictions, the core aspects of the trust remained the same. In South Africa, the courts played an extensive role in developing trust law. This was also the case in the UK. This resulted in both the South African and UK law of trust being largely uncodified. Belgium did not subsume the trust in their legal system. Instead, they elected to only create legislation regarding the recognition and control of foreign trusts. This is despite the fact that Belgium did not sign or ratify the Hague Convention. This raises the question of whether the Hague Convention successfully achieved its aim. Notwithstanding the former, the one big negative aspect of Belgium's trust framework is the enforcement of the forced heirship rules. This may very well make Belgium unappealing to many. In addition, Belgium does have various trust-like entities.

In both South Africa and the UK, the parties to a trust are largely the same. In some instances, the terminology differs, but the roles and duties are similar. The founder or settlor is the person who establishes the trust, which can be one or more persons. The founder creates the trust deed, transfers the property to be held in trust and appoints the trustees. In both jurisdictions, the trustee is the person who manages the trust in accordance with the trust deed. In South Africa, there is no limitation to the number of trustees, but in the UK, under certain circumstances, it is limited to four trustees. Unlike the UK, in South Africa, it is a requirement that a trust should have an independent trustee. A trust will not be invalid in the absence of the latter but may attract adverse consequences. In both jurisdictions' trustees can be appointed by various parties, depending on the facts and circumstances. Following from the former,

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it is also necessary that the trustee accepts their appointment. Neither jurisdiction has qualification requirements for trustees, but there are certain grounds that will disqualify a person from being suitable for such a position. In each jurisdiction, there is a process to follow, before the trustee can act on behalf of the trust. In South Africa, this is more extensive. The trustee must obtain authorisation from the Master before they can act. In the UK, the role of trustee can be further subdivided into management and custodian trustees. This gives rise to various benefits if used correctly. It is submitted that this aspect can be beneficial if implemented in South Africa.

In both South Africa and the UK, the beneficiary is the person who will benefit from the trust. It is a requirement that the beneficiary is ascertainable; failing this, the trust will be invalid. The determination of beneficiaries can be by name, through degree of consanguinity, from a specific class or an impersonal object. The former is the founder or settlor’s prerogative. In the UK, this beneficiary principle is enforced very strictly. In both jurisdictions, the rights of beneficiaries depend on the type of trust and the terms of the trust deed.

In the UK, as a general rule, beneficiaries have a proprietary right in the trust property. This is in contrast to that of South Africa. In both jurisdictions, the beneficiaries have a personal right against the trustees if a breach of trust should occur. The result of the former is that different remedies are available in each jurisdiction to protect the interest of the beneficiaries. Even though the beneficiaries do not have a real right in the trust property in South Africa, adequate protection is still provided. Often beneficiaries can be divided into income and capital beneficiaries. With regard to the beneficiaries’ interest in the trust property, a further distinction can be made between those beneficiaries with a vested right and those with a contingent right. In the case of discretionary trusts, the rights will always be contingent. Depending on the aforementioned, important consequences follow. Furthermore, a trust for an abstract purpose is invalid in the UK. The only exception is charitable trusts. In both South Africa and the UK, the settlor, trustee or beneficiary can be either a natural or a legal person. Furthermore, one person can have multiple roles as long as they are not the only person serving all three functions. Besides the above-mentioned parties, it is also possible to have a protector or enforcer. Their task is to ensure that the trustees manage and administer the trust in accordance with the stipulations of the trust deed. These parties are not recognised in South Africa or in the UK. It remains to be seen whether the courts are willing to recognise such roles, to what extent, or

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will they simply disregard those provisions. It is submitted that in both jurisdictions, the trust law must still be developed to accommodate the aforementioned parties. If these roles are properly regulated, it can provide additional protection to the beneficiaries and ensure that the settlor’s wishes are executed.

Unlike in South Africa, the notion of split ownership is recognised in the UK. This means one person holds the legal title of the property, while another holds the equitable interest. In such a construct, both parties have a real right in the property. Neither jurisdiction regards a trust as a juristic person. Therefore, a trust does not have a separate legal personality. In both jurisdictions, the trust acts through the trustees. In both South Africa and the UK, the core idea of a trust is the separation between ownership or control, and that of enjoyment. This means the trustees manage and administer the trust property for the benefit of the beneficiaries. In both jurisdictions, the trustees are only entitled to trust assets, if they are, and to the extent that they are also beneficiaries of the trust.

In South Africa, the English law of trusts has not been subsumed. Instead, the courts have developed a uniquely South African trust. It is undeniable that English influence played a role in shaping the former, but substantial differences remain.

In contrast to the UK, in South Africa, the beneficiaries only have a personal right against the trustees, with the exception of *bewind* trusts. This enables them to ensure that the trustees comply with the trust deed. This personal right further confers the beneficiaries with the necessary *locus standi* to take legal action against the trustees if the trustees do not act within the parameters of the trust deed.

In addition, in a South African context, the notion of joined tenancy is not formally recognised. However, there is a strong argument to be made that South Africa does follow the rule of survivorship in practice, which is based on the concept of joined tenancy. It is submitted that this should be made clearer in the South African trust law.

In both jurisdictions, the trust property constitutes a separate estate and should be kept separate from that of the trustee’s private property. In South Africa, the trust property does not form part of the trustee’s personal estate or that of the beneficiaries unless vesting has already occurred. This contrasts with that of the UK, where the beneficiaries’ interest forms part of their personal estate. This is due to the real right they have in the trust property. The only exception to the latter is where it concerns a discretionary trust.

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As a result of the separate trust estate in both jurisdictions, the trust's creditors are limited to the trust property only. This means the trustees' and beneficiaries' personal property cannot be attached. The converse is also true; the trustee's creditors are also limited to the trustee's private property.

In South Africa, under certain circumstances, specific legislation treats trusts as a legal person for purposes of that act. This leads to various anomalies in practice.

Unlike in South Africa, in the UK, the beneficiaries are able to direct or instruct the trustees to perform a specific task under certain circumstances. This is made possible by the concept of equitable ownership. The requirements were set out in *Saunders.*[463] This principle is not applicable where it concerns a discretionary trust, or at least the position is still unclear. The former illustrates that in the UK, a much greater emphasis is placed on protecting the beneficiaries than on upholding the settlor's wishes. It is submitted that the South African approach is preferred in this case. Unless the trust deed is carefully drafted, this principle may serve as a deterrent to creating a trust if the beneficiaries can potentially circumvent the trust completely.

Neither jurisdiction has a set list of types of trusts, but it rather depends on factors such as the purpose of the trust, the rights of beneficiaries, the powers of the trustees and the method of formation. The trust types can be categorised into two overarching categories in both South Africa and the UK, even though the groupings differ substantially. In the case of South Africa, it is the *bewind* trust and ownership trusts. The former is where the beneficiaries have ownership rights in the trust property and the trustees merely administer it. The latter category is where the beneficiaries only have a personal right against the trustees, but ownership of the trust property rests in the trustees. In the case of the UK, the categories are express trusts and imputed trusts. Here, the former is where the settlor, by means of a conscious act, intentionally creates a trust. Under this option, the trust can take various forms. The latter arises in defined circumstances to address injustice by the application of legal rules and principles. These rules are a combination of statutory intervention and development by the judiciary.

Ownership trusts are the most popular in South Africa, while express trusts are widely used in the UK. The *bewind* trust in South Africa and the imputed trust in the UK are only mentioned for completeness, but the discussion primarily focuses on

[463] (1811) 4 Beav 115.

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ownership and express trusts, respectively. To this extent, there are no imputed trusts recognised in South Africa. These can take the form of constructive or resulting trusts. Their application can play a great role in addressing an injustice or unconscionable act. It is submitted that such a construct can be of benefit in the South African trust law, especially in cases where it concerns the abuse of the trust.

The types of trusts are very similar in both South Africa and the UK. In the case of the UK, the list is slightly more extensive. Unlike in South Africa, secret trusts are recognised. In addition, due to the beneficiary principle, it is not possible to form a protective trust in the UK.

In both jurisdictions, there are various means by which a trust can be created. These may be through a will, court order, contractual agreement or statutes. In South Africa and the UK, the most widely used method is through a contract (the so-called *inter vivos* trust) or a will (the so-called testamentary trust). In both jurisdictions, it is possible to either form a trust in writing or orally. Even though oral trusts are valid in South Africa, it does not fall within the ambit of the TPCA. In South Africa, the courts can also create trusts if it is suitable in the circumstances. This can be any type of trust which is applicable in the specific case. In the UK, however, if the courts create a trust, it is usually a constructive or resulting trust. In the UK, the exact formalities will first depend on the method of the declaration and the type of property transferred to the trust. In addition, both jurisdictions must comply with the requirements for a valid trust. In the UK, a settlor can unilaterally declare that property is held on trust for some other person. In both jurisdictions, the founder must be the property owner before it can be transferred to the trust. Furthermore, it is possible in both jurisdictions for the settlor to reserve certain rights or powers for him or herself. It will depend on the type and extent of these powers and whether the courts will uphold it. Depending on the circumstances and the wording of the trust deed, it is usually not possible for the settlor to unilaterally revoke the trust unless provision has been made explicitly for such a right. In such a case, it will attract adverse tax consequences.

Unlike in the UK, the rule against perpetuity was not adopted in South Africa. The result of the former is that there is no limitation on the duration of a trust in South Africa. This is in contrast to the UK, where the rule applies. According to the rule, no trust can exist for a period exceeding 125 years. The only exception is charitable trusts. It is submitted that the South African approach is preferred. It is debatable if the rationale for the rule against perpetuity is still relevant in today’s time.

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With regard to the requirements for a valid trust, the requirements in both jurisdictions are largely the same. In both South Africa and the UK, it is paramount that the settlor has the necessary intention to establish a trust. Without the former, none of the other requirements makes sense. This can be regarded as the core requirement. If one examines the intention requirement closer, there are, however, important differences in South Africa compared to the UK. The most noteworthy is encountered in the realm of the sham trust. The basic concept and definition of what constitutes a sham are very similar in both jurisdictions. Notwithstanding the former, the classification and criteria of a sham trust do differ substantially.

In South Africa, a distinction is made between a sham trust and the abuse of the trust. In the UK, however, both occurrences are regarded as a sham. This means that the ambit of the sham concept is much wider in the UK than in South Africa.

In both jurisdictions, the courts played a crucial role in developing the requirements for a transaction to be regarded a sham. The essence of the determination is whether the parties intended to create something else than is portrayed to the outside world. In both South Africa and the UK, the courts held that a component of disguise or dishonesty must exist. In the case of the UK, the courts went a step further. They held that it must be a collective intention to mislead or deceive third parties. In addition, both jurisdictions will take all the facts and circumstances into account, including the parties' subjective intentions.

In the UK, the courts further held that the degree of control of the settlor over the trustees and their decisions, and/or the trust property, gives a strong indication of whether the trust is a sham. This is in contrast to the approach followed in South Africa. In the case of South Africa, the degree of control of the founder over the trustees or the trust property is not relevant for the sham enquiry. The former is rather an indication that the trust is being abused. The determination of the abuse of the trust has its own separate requirements from that of the sham enquiry. It concerns how the trust is administered instead of whether a trust was validly formed. It is submitted that the distinction made in South African law is the preferred approach to this problem. It should be remembered that both the sham question and the abuse of the trust are distinct issues with their own complexities and should be kept as such. In this regard, some authors in the UK advocate for following the South African approach. Even though some South African authors have previously confused the sham doctrine and

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the abuse of the trust notion, it seems like there is much greater consensus in South Africa than there is in the UK.

In both jurisdictions, the underlying principles of trust administration are largely the same, even though it is expressed in different words. The essence can be summarised as acting with the necessary duty of care, managing the trust property in accordance with the trust deed, and remaining fair and impartial while doing so. In South Africa, the Master oversees or supervises all trust affairs, while the courts fulfil this role in the UK. In South Africa, any party is able to approach the courts if there is a dispute regarding trust matters or if they are not satisfied with a decision by the Master. Unlike in the UK, the Master is responsible for the administration of trusts and forms the first port of call. Recourse to the courts is reserved if the former is unsuccessful or if it falls outside the ambit of the Master's jurisdiction. It is submitted that the South African approach is the preferred method. Having a dedicated entity in charge of routine trust matters and thereby limiting such cases on the court roll frees up resources for more complex cases where juridical intervention is appropriate.

Trusts in South Africa are much more regulated than trusts in the UK. For example, in South Africa, it is required to register all trusts (save for oral trusts) with the Master. It is further necessary to lodge the trust deed and any amendments thereto with the Master, the Master must be notified of all appointments and removals of trustees, and all trustees must receive a letter of authorisation before they can act with trust property.

In both jurisdictions, there are limitations on access to information pertaining to trust affairs. Even though the trustees are required to keep accurate records, this only needs to be disclosed under specific circumstances. In the case of South Africa, the Master has the discretion whether or not to grant the request for the information. The only requirement is that the party has a sufficient interest in the trust. In the UK, this determination will be made by the courts. Normally it will be restricted to beneficiaries with a proprietary right in the trust property. Only the information directly relevant to that specific right will be shared in such a case. It is submitted that trust information is easier to obtain in South Africa than in the UK. This may contribute to ensuring responsible governance by trustees.

The duties and powers conferred upon trustees are largely similar in South Africa and the UK. To this extent, the general rule in both jurisdictions is that the trustees are required to act jointly unless the trust deed prescribes a different minimum quorum or if the statutory exceptions apply. Furthermore, under specific circumstances, trustees

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are able to delegate their duties or powers, but total abdication is not permitted. In both jurisdictions, trustees are entitled to reasonable remuneration for services rendered. All conduct of trustees must fall within the scope of the trust instrument. Failure to do so would leave the trustees personally liable. This is echoed by the statutory standard of care expected from a trustee. This can be summarised as that which can be reasonably expected from a person who manages the affairs of another. In South Africa, any attempt or provision that exempts or indemnifies a trustee from breach of trust would be void. This position is in contrast to that of the UK, where it is possible for trustees to limit or exclude their liability. Such a clause will only be valid if the applicability is restricted to negligence and/or gross negligence. No attempt to indemnify trustees for dishonesty or fraudulent conduct is permitted. It is submitted that even though the rationale behind the approach followed in the UK is understood, the stricter position of South Africa is preferred. Once again, this will aid in improving good governance among trustees. Even though there are no qualification requirements for trustees, this will ensure that those nominated for the role take their responsibilities seriously should they accept the appointment. It is further an illustration of the interplay between the private and public components of trust affairs.

With regard to investments by trusts, the point of departure in both jurisdictions is the same. Before anything else, the trust deed must be consulted. The statutory provisions will apply only if and when the trust deed is silent on the matter. In the UK, the legislation contains extensive provisions in this regard. In the case of South Africa, in such a case, the general principles as set out by the courts will be followed.

In recent times both South Africa and the UK moved away from restricting trust investments to specific asset classes. It was believed that the preservation of wealth should take priority above asset growth. This narrow view hindered investment options and the trustees' discretion significantly.

The modern approach is similar in both jurisdictions. In South Africa, trustees are free to invest where and how they see fit as long as they comply with the stipulations of the trust deed and do so with the necessary duty of care and skill. In the UK, the investment process is much more regulated. Before any investment is made, the trustees must consider the standard investment criteria. Therefore, the investments must be suitable for the trust, and the portfolio of investments must be sufficiently diversified. Both of these requirements revolve around limiting the level of risk to which the trust fund is exposed. In addition, there is an obligation on the trustees to seek

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proper advice before making any investment on behalf of the trust or if contemplating whether to vary existing investments. The trustees are not bound by the advice and may well elect not to follow it. In determining whether the trustees' investment discretion was exercised properly, it will be measured against the standard of reasonableness. Furthermore, in both jurisdictions, trustees are required to balance the interests of both income and capital beneficiaries alike. This means that both considerations should be taken into account when deciding on an investment strategy. It is submitted that the new liberal approach towards trust investments in both jurisdictions is welcomed. Furthermore, the additional safeguards put in place by the UK legislator are preferred above the total unregulated approach in South Africa. It allows the trustees the freedom to select investment options but also ensures that they are cognisant of important factors.

In conclusion, the approach followed in the two jurisdictions is not identical. Even though there are large similarities, important differences are apparent. These differences developed in response to the unique conditions and circumstances of each country. However, some aspects are preferred in South Africa to that of the UK. Similarly, there are areas where South Africa can learn from the approach followed in the UK. Both these jurisdictions may influence Belgium's trust law if it elects to enact such a framework in the future.

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CHAPTER 3: TAX HAVENS

3 1 Introduction

Tax havens have attracted ever-increasing attention and scrutiny from policymakers in recent years. They have been singled out as the root cause of many of the current problems plaguing the world. At the top of the list are the fiscal shortfalls troubling governments across the globe. The interest in tax havens reflects their disproportionate role in the global economy, particularly their centrality to many of the important current policy debates in taxation, including international tax competition and tax avoidance activities.

This chapter introduces the tax haven concept and the notion of quasi-tax havens to the reader and provide a thorough overview of the core aspects. However, this should not be construed as a discussion on all related topics, but merely to provide the required context.

The chapter will also touch on the most crucial questions, discuss the controversial and conflicting views among authors, and attempt to explain or clarify the current position. This will serve as the background and foundation for subsequent chapters, especially considering the major role that tax havens play in the global economy, the so-called offshore trust and investment market, as well as the negative connotations associated with such jurisdictions. Due to the importance and complexity of the tax haven subject to the greater dissertation, it is paramount to have a reasonable understanding of the current problems surrounding tax havens in their current form, as well as the potential they offer if utilised correctly. Only then can one focus on possible solutions to the overarching problem, but before one can craft a solution to the problem, one must understand the current offerings. In other words, what jurisdictions competing for investment, offer.

If the aforesaid context is omitted, the value of the discussion and recommendations that follows may very well be lost. Unfortunately, the emotionally loaded nature of the tax haven and associated terminologies contributes to the complexity. In addition, throughout the proceeding chapters, references will be made to tax haven terminology and concepts when discussing related topics. In light of the aforesaid, when discussing the use of trusts for investments, one cannot really omit discussion of tax havens. Thus although a fairly lengthy and at times detailed

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discussion of tax havens and the associated terminology is included in the chapter, this is a necessity. The complexities associate with tax havens and their terminology demands this.

These objectives will be achieved by addressing the following questions:

1. How were tax havens formed?
2. What is a tax haven? Alternatively, are there other terminologies?
3. How are tax havens classified? Alternatively, are all tax havens the same?
4. Why are there tax havens?
5. Can all countries become tax havens? Alternatively, what are the requirements?
6. What benefits are there in becoming a tax haven? Alternatively, what is the appeal of using tax havens?
7. What effects do tax havens have on the global economy?
8. How can tax havens be stopped? Is anyone doing anything to curb the trend?
9. Can South Africa become a tax haven? Is that advisable?

The study will illustrate the practical relevance of each section discussed by referring to Mauritius as an example jurisdiction. Depending on the context, references to other jurisdictions may be included if appropriate. For example, under the quasi-tax haven section, the concept will be applied to the USA's FATCA regime and Belgium's excess profit regime as two possible examples.

This will also emphasise the close link between trust law and tax havens.

In the context of South Africa and the greater African continent, the significance of Mauritius cannot be over emphasised. Mauritius has been described as the African success story, one of the few countries that was able to modernise and diversify their economy.[1] Moreover, it is also one of the few countries that have sustained extended periods of high growth. Similar to South Africa, the geographic location of Mauritius is perfectly situated to promote and facilitate investment into the continent. In recent times, Mauritius has also made the necessary reforms to position itself as an attractive investment destination and serves as a crucial gateway into Africa.[2] In addition, both

[1] National Bureau of Economic Research "Mauritius: African Success Story" (2011) <https://www.nber.org/digest/may11/mauritius-africa-success-story> (accessed 27-04-2023).

[2] Ali Zafar "Mauritius: An Economic Success Story" (2014) <https://documents1.worldbank.org/curated/en/304221468001788072/930107812_2014082530900808/additional/634310PUB0Yes0061512B09780821387450.pdf > (accessed 27-04-2023).

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Mauritius and South Africa form part of the emerging market economies, even though Mauritius is also regarded as a tax haven by many. On numerous fronts, South Africa is in direct competition with Mauritius for investment. As part of this reform process, Mauritius has modernised their trust legislation. To this extent, Mauritius has introduced an innovative trust framework. There were also noteworthy changes to their already appealing tax system. In many aspects, Mauritius is leading the way in simplifying and modernising legislation. Due to the similarities and shared characteristics of South Africa and Mauritius, Mauritius has been identified as an important jurisdiction for this dissertation. The mistakes made, lessons learnt, and experiences of Mauritius can offer invaluable insight to South Africa. Lastly, it poses the opportunity for South Africa to improve and augment the value proposal to potential investors, thereby positioning itself above the competition.

The aim of this chapter is not to discuss every possible aspect of tax havens nor to explore each topic in detail. It also does not seek solutions to the multifactorial problems surrounding tax havens. It is also not the intention to discuss the various debates and controversies currently raging among the academic fraternity in great detail. The goal is merely to prepare the reader for the discussions that will follow by providing a holistic and well-represented view of tax havens. Due to the nature of the topic, this chapter discusses the conflicting perspectives and indicate the view or meaning that is followed throughout the rest of the chapter. This ensures an accurate picture of the current position while also indicating areas that are still under discussion or where there is no consensus at this stage.

3 2 Background

Contrary to public belief, the biggest tax havens are not idyllic island nations but rather countries in Europe, the United Kingdom ("UK") and the Americas.[3] These powerhouses have had a direct and paramount role in developing tax havens as they are known today.[4]

[3] N Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 14.
[4] R Palan, R Murphy & C Chavagneux *Tax Havens: How Globalization Really Works* (2010) 7.

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Taxation can be traced back to ancient times with the Egyptians, Roman and Greek empires among the first to levy taxes.[5] The notion of minimising one's taxes has been around since the concept of taxation was first introduced. There are signs that tax havens originated in ancient Greece, where neighbouring islands were used as a refuge where traders would store their goods to avoid the 2% Athens tax on imports and exports.[6] There are *numerous other examples in history where discrepancies between jurisdictions' tax laws were* used to avoid or reduce taxes.[7]

Notwithstanding the former, the origins of modern tax havens can be traced back to Vienna, Austria, in 1815, when Switzerland's neutrality was established at the Vienna Congress.[8] Subsequently, various key developments took place worldwide, shaping the environment that made the evolution of tax havens possible.[9] For a large part, these events were separate and distinct from one another but indirectly laid the foundation for tax havens to flourish. Only after World War I did some countries create policies and enact legislation to become a tax haven.[10] In these cases, it was regarded as a developmental strategy.

3 2 1 Early developments

The first big development took place in the late nineteenth century when the United States of America ("USA") embarked on ground-breaking reforms. In order to attract business, states created a new liberal corporate framework with substantially relaxed incorporation laws and attractive corporate tax rates.[11] The notion originated in the

[5] BJ Croome, E Muller, C Louw & R Williams *Tax Law: An Introduction* (2013) 2. Encyclopedia Britannica "Principles of taxation" (undated) *Britannica* <https://www.britannica.com/topic/taxation/Principles-of-taxation> (accessed 15-02-2022).
[6] RA Gordon "Tax havens and their use by United States Taxpayers: An overview. A report to the Commissioner of Internal Revenue the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy)" (12-01-1981) *Department of the Treasury, Internal Revenue Service* <http://archive.org/stream/taxhavenstheirus01gord/taxhavenstheirus01gord_djvu.txt> (accessed 15-02-2022).
[7] Gordon "Tax havens and their use by United States Taxpayers: An overview. A report to the Commissioner of Internal Revenue the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy)" (12-01-1981) *Department of the Treasury, Internal Revenue Service*.
[8] C Farquet "The rise of the Swiss tax haven in the interwar period: an international comparison" (2012) 20 *EHES* 4.
[9] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 21.
[10] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 8.
[11] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 53.

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State of New Jersey but soon spread to other states, such as Delaware.[12] What originally started as a way to generate revenue quickly gave rise to one of the core pillars of the modern tax haven. The USA is, therefore, not only the epicentre of tax havens but also the pioneer of flexible incorporation laws.

The development of the second pillar occurred in the UK, where the British courts recognised the concept of virtual residency. In *Egyptian Delta Land and Investment Co. Ltd. v Todd*,[13] the courts held that even if a corporation is registered in the UK, it will not be liable for tax in the UK as long as it does not have any activities in the UK. This technique of separating the place of incorporation and that of business activities forms the core of the tax haven phenomenon.

Over the following years, this ruling was applied and expanded on by the UK crown dependencies and UK territories alike.[14] Unsurprisingly, some of these jurisdictions, such as the Cayman Islands, became the frontrunners in the field.[15] One possible explanation for this is that these jurisdictions were perceived as safer compared to other small independent island states. This perception can possibly be attributed to the support received by the UK, in contrast to the competitors.[16]

During the same period, the UK reformed it is trust law.[17] This new framework made it easier for people to establish or transfer property to trusts. In addition, the trust concept spread to other commonwealth countries.[18] In many instances, the UK trust law was adopted and subsequently adapted to suit the specific jurisdictions' needs. This was also true for the British dependencies and territories.

In response to the depression and the series of bankruptcies in neighbouring countries, the Swiss assembly began strengthening the Swiss banking system. As a result, the legislator enacted the Bank Act of 1934.[19] The key aspect of this act is the strengthening of the bank secrecy principle. This was achieved by placing the secrecy principle under the ambit of criminal law. The significance of the former is that absolute

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[12] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 110.
[13] 1928 14 TC 119.
[14] R Palan "History of tax havens" (01-10-2009) *History and Policy* <http://www.historyandpolicy.org/policy-papers/papers/history-of-tax-havens> (accessed 15-02-2022).
[15] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 27.
[16] R Palan "International financial centres: The British Empire, city states and commercially oriented politics" (2010) 11 *TIL* 9.
[17] See the Trustee Act 1925.
[18] T Graham "Trusts in prime jurisdictions" (2011) 17 *T&T* 137.
[19] Swiss Federal Act on Banks and Savings Banks 1934.

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silence is demanded relating to any professional secret. In effect, this means that information relating to Swiss bank accounts is protected from any government, including that of Switzerland. Any form of disclosure or enquiry into such details is a criminal offence. This absolute secrecy was the third and final pillar which made the emergence of tax havens possible.

3 2 2 The advent of tax havens

The first tax havens that resembled their modern forms emerged in the 1920s and 1930s.[20] During this time, there was an increased need for finances by various states. This can be attributed to the effects and consequences of World War I.[21] This resulted in higher taxes across the continent. In response to the former, wealthy individuals and corporations actively explored ways to reduce their tax burden. This was recognised as an opportunity for some countries to create an attractive fiscal system.[22] Switzerland, Liechtenstein and Panama led the charge.[23]

Aside from incorporating the three pillars discussed above, additional developments also took place. To this extent, new legal entity types were created.[24] The most well-known include the foundation and the Anstalt. Furthermore, some of these entities, such as the Liechtenstein Anstalt, had no requirements and restrictions pertaining to shareholding.[25] This trend later became commonplace among tax haven jurisdictions. There are also signs that Bermuda, the Bahamas, and Jersey were used to varying degrees as tax havens during this period.[26]

3 2 3 The Euro market regime

The devaluation of the British pound in the 1950s was one of the factors which gave rise to the development of the Euro Markets regime.[27] This served as a catalyst for the

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[20] Palan "History of tax havens" (01-10-2009) *History and Policy*.
[21] C Farquet "The international tax evasion market in the interwar period" (2012) *L'Économie politique* 54 95.
[22] Farquet (2012) *EHES* 6.
[23] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 34.
[24] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.
[25] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 4.
[26] Palan "History of tax havens" (01-10-2009) *History and Policy*.
[27] J Hodges "Offshore tax havens in spotlight after 200-year history" (03-05-2013) *Bloomberg* <https://www.bloomberg.com/news/articles/2013-05-03/offshore-tax-havens-in-spotlight-after-200-year-history> (accessed 16-02-2022).

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UK to position itself in such a way as to capitalise on the expanding offshore financing market.[28] Today, London is the largest international financial centre.[29]

The Euro Market is an inter-bank or "wholesale" financial market which, due to this implicit understanding between the Bank of England and the commercial banks, is not regulated by the bank. But since the transactions take place in London, no other authority regulates the market, and hence it became effectively unregulated.[30] The only caveat is that these transactions must be in a foreign currency and between non-British clients.[31] This practice even enjoyed the endorsement of the UK courts.[32] There are various theories on how and why the UK decided to explore this line of development.[33]

3 2 4 The surge of tax havens

It was not until the 1960s that tax havens grew rapidly.[34] There are numerous reasons for this, which include the rise of capitalism, liberated financial systems and higher taxes, to name a few.[35] In addition, events such as the expansion of the UK and American banks' Euro Market activities to other jurisdictions also played a substantial role.[36] During this time, tax havens were no longer limited to Europe and the Caribbean but also spread to the Pacific and Asia as well.

During this period, the initial evolution of trust law began. Unsurprisingly, it was the British dependencies and territories who were the pioneers in modernising and revolutionising trust legislation.[37] Many of the restrictions, as known in the English

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[28] N Shaxson "Tax havens: Britain's second empire" (29-09-2019) *Tax Justice* <https://www.taxjustice.net/2019/09/29/tax-havens-britains-second-empire/> (accessed 17-02-2022).
[29] Palan (2010) *TIL* 11; Z/Yen Limited "The competitive position of London as a global financial centre" (2005) *Zyen* <https://www.zyen.com/media/documents/LCGFC.pdf> (accessed 16-02-2022); A MacAskill, S Cruise & H Jones "London retains global finance throne amid Brexit chaos" (15-10-2019) *Reuters* <https://www.reuters.com/article/uk-britain-eu-finance-analysis/london-retains-global-finance-throne-amid-brexit-chaos-idUSKBN1WU0I8> (accessed 16-02-2022).
[30] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*; Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 132.
[31] J Hodges "Offshore tax havens in spotlight after 200-year history" (03-05-2013) *Bloomberg* <https://www.bloomberg.com/news/articles/2013-05-03/offshore-tax-havens-in-spotlight-after-200-year-history> (accessed 16-02-2022).
[32] Hodges "Offshore tax havens in spotlight after 200-year history" (03-05-2013) *Bloomberg*.
[33] G Burn "The state, the city and the Euromarkets" (1999) 6 *RoIPE* 227.
[34] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 136.
[35] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 83.
[36] Palan "History of tax havens" (01-10-2009) *History and Policy*.
[37] AS Hofri-Winogradow "Trust proliferation: A view from the field" (2017) 31 *TLI* 154.

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trust, were removed or substantially relaxed. To this extent, the USA also played a paramount role in reshaping trust law.[38] In addition, in response to the changing external environment and to complement their developmental strategy, new novel trust types and innovative applications were created and marketed to the world.[39] Trusts became increasingly important in the financial system.[40]

This rise in the popularity of trusts, the diverse range of applications for which trusts are used, and the growing media attention received also led to increased negative perceptions of trusts.[41] Notwithstanding the wide range of legitimate functions fulfilled by trusts, among some circles, trusts became an analogy for tax evasion and other criminal activities.[42]

Over the following decades, tax havens spread to other areas of the world, such as the Indian ocean, Africa and post-Soviet republics.[43] In all of these geographic locations, the same tax haven framework was used and expanded on – copying legislation and policies from the leaders in the field.[44] This typically included but was not limited to provision for relaxed regulations, no or low taxation for some entity types, bank secrecy laws, trust companies laws and offshore insurance laws.[45]

It was not until the late 1990s that the world realised the extent and wide reach that tax havens had over the global economy. By this time, tax havens were no longer supplementary but rather embedded into the finance system.[46] Depending on the definition used, there were approximately 60 to 100 tax havens by the 1990s.[47]

As the popularity of tax havens increased and the range of offerings expanded, the dangers and negative consequences became clearer.[48] To this extent, the global

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[38] RH Sitkoff & MM Schanzenbach *Jurisdictional Competition for trust funds: An empirical analysis of perpetuities and taxes* (2005)
[39] Hofri-Winogradow (2017) *TLI* 156.
[40] B Harrington "Trusts and financialization" (2017) 15 *S-ER* 33.
[41] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.
[42] A Knobel "Trusts: weapons of mass injustice?" (2017) *Tax Justice* <https://www.taxjustice.net/wp-content/uploads/2017/02> (accessed 16-02-2022).
[43] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 25.
[44] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 7.
[45] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 146.
[46] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*; Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 146.
[47] Hodges "Offshore tax havens in spotlight after 200-year history" (03-05-2013) *Bloomberg*.
[48] Tax Justice Network "Tax Havens & Financial Crisis" (undated) *Tax Justice* <https://www.taxjustice.net/topics/finance-sector/tax-havens-financial-crisis/> (accessed 17-02-2022); R Baker "Illicit financial flows from Africa: Their loss; not our gain" in O-H Fjeldstad & AJR Dahl (eds)

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drive against tax havens intensified.[49] For this reason, there was an upsurge in the organisations and the initiatives proposed to address this growing problem.[50] Each intervention had its own set of challenges, with varying levels of success.[51]

3 3 5 Mauritius

The island nation of Mauritius is situated in the Indian ocean, off the south-eastern coast of the African continent.[52] Mauritius was a former colony of the UK during the English Empire's rule.[53] The African nation obtained its independence in 1968 and formally became a republic in 1992.[54] Due to the historical link to the UK, Mauritius inherited many English systems and processes.[55] France, that also controlled

Lifting the Veil of Secrecy: Perspectives on International Taxation and Capital Flight From Africa (2017) 58; Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*; Tax Justice Network "The price of offshore revisited" (22-07-2012) *TJN* <https://tjn-usa/storage/documents/The_Price_of_Offshore_Revisited _-_22-07-2012/> (accessed 17-02-2022); D Dharmapala "What problems and opportunities are created by tax havens?" (2008) 24 *ORoEP* 663; Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 146.

[49] RT Kudrle & L Eden "Campaign against tax havens: Will it last? Will it work?" (2003) 9 *SJoLBF* 39.

[50] C Pragua "Addressing tax evasion and tax avoidance in developing countries" (2010) *Tax Compact* <https://www.taxcompact.net/resource/addressing-tax-evasion-and-tax-avoidance-developing-countries> (accessed 17-02-2022); M Meizner *Automatic exchange of information as the New Global Standard: The end of (Offshore Tax Evasion) History?* (2017) paper presented at the *2nd Turkish-German Biennial on International Tax Law in Istanbul*, 03-03-2016 (available at https://ssrn.com/abstract=2924650); P Vandenberg "Exchanging information to combat tax evasion" (2015) 3 *ADBI* 3; Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 146; The Economist "Storm survivors" (14-02-2013) *The Economist* <https://www.economist.com/special-report/2013/02/14/storm-survivors> (accessed 17-02-2022).

[51] R Woodward "A strange revolution: mock compliance and the failure of the OECD's international tax transparency regime" in P Dietsche & T Rixen (eds) *What is Wrong With it and how to Fix It* (2016) 105; J Johannesen & G Zucman "The end of bank secrecy? An evaluation of the G20 tax haven crackdown" (2014) 6 *AEJ* 71.

[52] Mauritius Attractions "The geography of Mauritius" (undated) *Mauritius Attractions* <https://mauritiusattractions.com/geography-of-mauritius-i-84.html> (accessed 18-02-2022); Tax Justice Network "Narrative report on Mauritius" (undated) *Tax Justice Network* <https://fsi.taxjustice.net/PDF/Mauritius.pdf> (accessed 18-02-2022).

[53] African Democracy Encyclopaedia Project "Mauritius: European settlement and the slave economy (1638-1835)" (2009) *EISA* <https://www.eisa.org.za/wep/mauoverview4.htm> (accessed 18-02-2022).

[54] The Commonwealth "Mauritius: History" (undated) *The Commonwealth* <https://thecommonwealth.org/our-member-countries/mauritius/history> (accessed 18-02-2022).

[55] Nations Encyclopaedia "Mauritius – location, size and extent" (2023) *Nations Encyclopaedia* <https://www.nationsencyclopedia.com/Africa/Mauritius-LOCATION-SIZE-AND-EXTENT.html#:~:text=Mauritius%20is%20situated%20in%20the,mi)%20off%20its%20northeastern%20coast.> (accessed 18-02-2022).

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Mauritius for some time, also greatly influenced the island.[56] Even today, after wide-reaching reforms, there is still a clear resemblance to the former empires.

Originally the Mauritian economy consisted mainly of agriculture and, to a lesser degree, tourism.[57] Realising the geological limitations and geographic opportunities, the government embarked on an economic diversification process.[58] Over the years, Mauritius invested heavily in infrastructure expansion and promoting tourism.[59] The journey to becoming an offshore financial centre ("OFC") started in 1989, as Mauritius sought to reduce their dependence on agriculture and develop additional economic sectors,[60] to position itself as a gateway to Africa and become the preferred investment destination on the African continent. Officials embarked on a plan to become the jurisdiction of choice for individuals and corporations that seek to invest in Africa. The introduction of the Banking Act of 1988[61] laid the foundation for the offshore industry.[62] This plan was solidified by enacting the Mauritius Offshore Business Activity Act 1992, which enabled foreign entities to incorporate companies with limited public disclosure, extremely low or no taxation, and high levels of privacy and asset protection.[63]

Aside from the aforementioned, during the 1990s and early 2000s, Mauritius also reviewed and reformed its legislation governing various business activities and tax

[56] PR Domingue "The historical development of the mixed legal system of Mauritius during the French and British colonial periods" (2002) 4 *UMRJ*.
African Democracy Encyclopaedia Project "Mauritius: European settlement and the slave economy (1638-1835)" (2009) *EISA*.
[57] Mauritius Attractions "Mauritius tourism" (2023) *Mauritius Attractions* <https://mauritiusattractions.com/mauritius-tourism-i-82.html> (accessed 18-02-2022).
[58] Mauritius Attractions "The geography of Mauritius" (undated) *Mauritius Attractions*.
[59] Mauritius Attractions "Mauritius Tourism" Mauritius Attractions "Mauritius tourism" (2023) *Mauritius Attractions*.
[60] V Tandrayen-Ragoobur "The services sector and economic growth in Mauritius. A bounds testing approach to cointergration" (2010) 16 *UMRJ*; RK Seechurn, P Ramtohul, K Googoolye, T Vaghjee-Rajiah & N Harris *A tale of five sectors in Mauritius: Agriculture, Textile/EPZ, Tourism, Financial Services and ICT/BPO … an employment perspective* paper presented at the *International HRD Conference*, Le Meridien Hotel, Pointe aux Piments, Mauritius, 17-18-10-2013 (available at https://www.researchgate.net/publication/259216962_A_tale_of_five_sectors_in_Mauritius_Agriculture_textileEPZ_tourism_financial_services_and_ICTBPOan_employment_perspective#fullTextFileContent).
[61] Banking Act 30 of 1988.
[62] Tax Justice Network "Narrative report on Mauritius" (undated) *Tax Justice Network*.
[63] AL Dahir "How an idyllic African island became a tax haven for some of the world's biggest corporations" (23-07-2019) *Quartz* <https://qz.com/africa/1673027/how-did-mauritius-become-a-global-tax-haven/> (accessed 22-02-2022).

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matters.[64] This includes, but is not limited to, trust law, company law, income tax, insurance and financial services.[65] As a consequence of the former, Mauritius boasts some of the world's most modern and innovative legislation.[66] This was all done to achieve the goal of becoming a renowned OFC and thereby attracting foreign direct investment (“FDI”).[67] Through this process, Mauritius also ascended the World Bank’s global ease of doing business (“GEDB”) ranking, even overtaking South Africa and other larger economies.[68] Similarly, Mauritius has achieved the highest ranking in Africa on the World Economic Forum’s (“WEF”) global competitiveness index (“GCI”).[69]

3 3 Terminology and classification

Even though the majority of people and organisations across the world recognise the risks and negative consequences of tax havens, there is still no universally agreed-upon definition of what constitutes a tax haven.[70] These discrepancies result in fragmented responses and ineffective policies.[71] Neither is there a generally accepted

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[64] M Hein “Mauritius: a brief history of business laws in Mauritius since 1968” (18-03-2018) *Mondaq* <https://www.mondaq.com/constitutional-administrative-law/686996/a-brief-history-of-business-laws-in-mauritius-since-1968> (accessed 20-02-2022).

[65] Offshore Trusts Guide “Offshore trusts report: Mauritius” (undated) *Offshore Trust Guide* <https://www.offshoretrustsguide.com/report/mauritius_tax_treatment.asp> (accessed 20-02-2022); LC Verbist “Mauritius: Offshore trusts in Mauritius” <https://www.mondaq.com/trusts/58110/offshore-trusts-in-mauritius> (accessed 20-02-2022).

[66] DK Seebaluk & LC Verbist “Mauritius: the preferred investment hub” (03-02-2020) *IFC Review* <https://www.ifcreview.com/articles/2020/february/mauritius-the-preferred-investment-hub/> (accessed 18-02-2022).

[67] M Blin & B Ouattara “Foreign direct investment and economic growth in Mauritius: evidence from bounds test cointegration” (2009) 117 *CRC* 48.

[68] World Bank Group “Doing Business 2020: Comparing business regulation in 190 economies” (2020) *WorldBank* <https://documents.worldbank.org/curated/en/688761571934946384/pdf/Doing-Business-2020-Comparing-Business-Regulation-in-190-Economies.pdf> (accessed 20-02-2022).

[69] K Schwab “The Global Competitiveness Report 2019” (2019) *World Economic Forum* <https://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf> (accessed 21-02-2022).

[70] Gordon “Tax havens and their use by United States Taxpayers: An overview. A report to the Commissioner of Internal Revenue the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy)” (12-01-1981) *Department of the Treasury, Internal Revenue Service*. The Economist “Storm survivors” (14-02-2013) *The Economist*; Tax Justice Network “Identifying tax havens and offshore finance centres” <https://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf> (accessed 17-02-2022).

[71] A Cobham, P Janský & M Meinzer “The Financial Secrecy Index: shedding new light on the geography of secrecy” (2015) 91 *EG* 283.

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comprehensive list of current tax havens. Each list rather focuses on specific types of tax havens or the particular methodology used.[72] In the absence of clear and verifiable criteria on how lists of tax havens are constructed, studies may fall prey to selection bias, which will invalidate their results.[73] Further complicating matters is the emergence of distinct but related terminologies used to refer to such jurisdictions. This includes harmful preferential tax regimes ("HPTR"), OFC and secrecy jurisdictions. Some authors further differentiate between sink-OFCs and conduit-OFCs.[74]

It is possible that a jurisdiction can satisfy the requirements for one or multiple of these classifications. Therefore, just because a country is regarded as an OFC does not necessarily mean it is a tax haven or HPTR as well. Conversely, the same is true for the other terminologies. Just because it complies with the requirements for a tax haven or HPTR does not automatically make it an OFC as well. It is also important to observe most jurisdictions may have some of these elements, but only a small number will satisfy all the requirements.

3 3 1 Offshore

Before one can analyse the more specialised terminologies, one must first understand the concept "offshore". On face value, this seems like a simple task, but after delving deeper, this is not necessarily the case. As with most terms, depending on the context, it can have differing meanings.

According to the Merriam-Webster dictionary, offshore can be defined as: "situated or operating in a foreign country".[75] Similarly, the Collins dictionary defines it as: "Offshore investments or companies are located in a place, usually an island, which has fewer tax regulations than most other countries".[76]

The first definition refers to the more literal meaning or geographic meaning. The latter refers to the meaning in the business context. In such a case, the term is equated

[72] Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*.

[73] The Economist "Storm survivors" (14-02-2013) *The Economist*; Johannesen & Zucman (2014) *AEJ* 71.

[73] Mauritius Attractions "The geography of Mauritius" (undated) *Mauritius Attractions*.

[74]

[75] Merriam-Webster "Offshore" (undated) *Merriam Webster* <https://www.merriam-webster.com/dictionary/offshore> (accessed 18-02-2022).

[76] Collins Dictionary "Offshore" (undated) *Collins Dictionary* <https://www.collinsdictionary.com/dictionary/english/offshore0> (accessed 18-02-2022).

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to that of tax havens. This illustrates that the word offshore is a loaded term, which can have differing meanings to various people.

In the academic world, various authors are of the opinion that the term tax haven is being replaced by the term offshore.[77] However, this change does little to address the constraints imposed by both the imprecise and binary nature of the terminology as it is understood and applied. The details of the aforementioned are discussed in the subsequent sections of this chapter. The latter view is evidently supported and coincides with the Collins dictionary's meaning, which emphasises the jurisdiction's tax treatment.[78]

On the one hand, for other authors, offshore refers to any cross-border economic activity,[79] which is more closely aligned with the Merriam-Webster dictionary's meaning.[80] On the other hand, there are authors who try and limit the wide reach, by restricting the use to a subset of economic trade.[81] For example only jurisdictions which have low regulation, low taxation, or strong secrecy provisions. Similarly, some elect to compare the aforementioned characteristics to those of onshore.[82]

According to Hampton, offshore can be defined as: "beyond the regulatory reach of the onshore authority".[83] This concurs with the view of Palan.[84] To a large degree,

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[77] RA Johns *Tax Havens and Offshore Finance:* A *Study of Transnational Economic Development* (1983) 49; SC Cobb "Global finance and the growth of offshore financial centers: The manx experience" (1998) 29 *Geoforum* 11; Hudson "Offshore onshore: Re-Shaping the financial regulatory landscape" in *Money and the Space Economy* 139-145; AC Hudson "Offshoreness, globalization and sovereignty: A postmodern geo-political *economy"* (2000) 25 *TotIoBG* 269; S Roberts "Fictitious capital, fictitious spaces: The geography of offshore financial flows" in S Corbridge, NJ Thrift & R Martin (eds) *Money, Power and Space* (1994) 91-115; B Maurer "Re-regulating offshore finance?" (2008) 2 *Geography Compass* 165.

[78] Collins Dictionary "Offshore" (undated) *Collins Dictionary* <https://www.collinsdictionary.com/dictionary/english/offshore> (accessed 18-02-2022).

[79] GM Grossman & E Rossi-Hansberg "Trading tasks: A simple theory of offshoring" (2008) 98 *American Economic Review* 1979; GL Clark & AH Monk "The scope of financial institutions: in-sourcing, outsourcing and off-shoring" (2013) 13 *Journal of Economic Geography* 281.

[80] Collins Dictionary "Offshore" (undated) *Collins Dictionary* <https://www.collinsdictionary.com/dictionary/english/offshore> (accessed 2020-02-18).

[81] T Wainright "Emerging onshore-offshore industries: The case of asset-backed securities markets in Europe" (07-08-2013) *Oxford University* <http://www.smithschool.ox.ac.uk/events/Wainwright_Offshore_FirstFullDraft070813.pdf> (accessed 20-02-2022).

[82] Clark & Monk (2013) *Journal of Economic Geography* 281.

[83] Hudson "Offshore onshore: Re-Shaping the financial regulatory landscape" in *Money and the Space Economy* 139-145.

[84] R Palan "Trying to have your cake and eating it: how and why the state system has created offshore" (1998) 42 *International Studies Quarterly* 627.

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this definition also focuses on the geographic location but emphasises the reach of regulatory powers. These two concepts usually coincide but this is not necessarily always the case. If this definition is applied, it potentially includes areas within the same borders, but may have certain regulations in place which prevent or limits the reach of regulatory authorities. The former gives rise to the situation where it is regarded as offshore but is still located onshore. This adds value to the discussion and understanding of the term but also immensely complicates matters further.[85]

According to Wojcik, the question pertaining to the meaning of offshore is not so straightforward. Therefore, instead of using a binary definition, it might be more sensible to regard the term offshore as a matter of degree.[86] Similarly, Zucman opted not to provide a definition but rather to discuss a list of characteristics.[87] Coinciding with the former, Coe discusses the problems of drawing a clear-cut division between offshore and onshore.[88] By doing so, he refers to "midshore finance centres", which is a chimera of both offshore and onshore. Furthermore, he emphasises the irony of using regulatory features as a criterion in the light that some onshore jurisdictions are far laxer than their offshore counterparts.

Alternatively, Wojcik defines offshore as: "jurisdictions that specialize in attracting the registration of [investment vehicles] with foreign sponsors".[89] The former definition focuses heavily on the place of registration or incorporation. It also emphasises certain entity types such as shell companies, trusts, special purpose vehicles, and mutual funds. It does further appear that this construction excludes prominent banking centres. This formulation was derived from the consensual approach pioneered by Palan et al,[90] and subsequently renamed to the expert agreement.[91]

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[85] Maurer (2008) *Geography Compass* 167.

[86] J Wojcik "Accounting for globalization: Evaluating the effectiveness of country-by-country reporting" (2012) *Employment, Work and Finance Working Paper* 12-08 4 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2163456> (accessed 14-12-2022).

[87] G Zucman "Tracking across borders: Tracking personal wealth and corporate profits" (2014) 28 *JoEP* 121.

[88] NM Coe, KPY Lai & D Wójcik "Integrating finance into global production networks (2014) 48 *RS* 761.

[89] Wojcik "Accounting for globalization: Evaluating the effectiveness of country-by-country reporting" (2012) *Employment, Work and Finance Working Paper* 12-08 4.

[90] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 45.

[91] Haberly D & Wojcik D "Tax havens and the production of offshore FDI: an empirical analysis" (2014) 15 *JoEG* 77.

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The expert agreement approach is a consolidated list of tax havens and OFCs, compiled over three decades by different international organisations and researchers.[92] The authors further held that "[w]hat defines offshore finance, however, is less the jurisdiction within which transactions are booked or conducted, than their conduct in a networked transnational legal space produced by the lack of a clear legal basis for multinational activity".[93]

Therefore, the question rather becomes, how does one move beyond the notion that offshore is a group of troublesome jurisdictions to realise that it is actually a pervasive aspect of the world economy. The objective should rather be to formulate an operational definition for research and policy purposes.

3 3 2 Tax haven

As a point of departure, if one turns to the dictionary meaning of tax haven, the Cambridge English Dictionary defines it as "a place where people live or invest money to pay less tax than they would in other countries".[94] Similarly, the Oxford Advanced Learner's Dictionary defines it as: "a place where taxes are low and where people choose to live or officially register their companies because taxes are higher in their own countries".[95] Clearly, the dictionaries' general and very broad definition of tax havens do not offer much assistance for such classification.

Conversely, The Economist defined a tax haven as a jurisdiction with "a composite tax structure established deliberately to take advantage of, and exploit, a worldwide demand for opportunities to engage in tax avoidance".[96] This definition brings one closer but still lacks identifiable characteristics that can be used in the determination.

Both the aforementioned definitions would include any country whose tax laws interact with those of another to make it possible to produce a reduction of tax liability

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[92] 77-79.
[93] 77-79.
[94] Cambridge Dictionary "Tax Haven" (undated) *Cambridge Dictionary* <https://dictionary.cambridge.org/dictionary/english/tax-haven> (accessed 2020-02-22).
[95] Oxford Learner's Dictionary "Tax haven" (undated) *Oxford Learner's Dictionary* <https://www.oxfordlearnersdictionaries.com/definition/english/tax-haven> (accessed 22-12-2022).
[96] C Doggart *Tax Havens and Their Uses* 10 ed (2002).

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in that other country.[97] The views of Hampton echo this.[98] Once more, this offers little assistance. In essence the same dilemma remains, this broad definition will virtually cover most of the globe.

According to the Tax Justice Network ("TJN") a tax haven is a jurisdiction that:[99]

1. enables one to evade or avoid the tax laws or regulations of other countries;
2. reduces of tax liabilities is an important element, but not decisive;
3. aims legislation at attracting non-resident business;
4. ensures that financial services form a major part of their economy; and
5. has a strong focus on secrecy.

It should be noted, the TJN does not distinguish between tax havens, HPTRs and OFCs. The TJN rather uses tax haven as an umbrella term to encapsulate all of the former.[100]

According to the author Nicholas Shaxson, the definition of a tax haven must extend far further than merely those jurisdictions with low tax rates. Besides the tax regime, it should also include strong secrecy provisions and flexible regulations.[101] This is largely in line with the view of the TJN. The Organisation for Economic Co-operation and Development ("OECD") defines tax havens as jurisdictions that: [102]

1. have no or only nominal taxes;
2. lacks effective exchange of information;
3. lacks transparency;
4. are absent of any substantial activity

In recent literature, authors attempted to devise more specific definitions by creating subcategories for the general tax haven concept. Eden proposed one classification for havens based on the type of taxation and another based on activity.[103] This expanded

[97] S Picciotto *International Business Taxation* (1992) 400.
[98] MP Hampton *The Offshore Interface: Tax Havens in the Global Economy* (1996) 79.
[99] Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*.
[100] Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*.
[101] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 9.
[102] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).
[103] L Eden & RT Kudrle "Tax havens: Renegade states in the international tax regime?" (2005) 27 *L&P* 100.

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on the work of Palan, Avi-Yonah and Kudrle, respectively.[104] Similarly, Palan, Murphy and Chavagneux elected to focus on the niche strategies, which each jurisdiction uses to differentiate itself from others.[105]

Even though one can argue that the authors mentioned above had varying success formulating subcategories to the tax haven concept, the overlapping nature and added complexity it brings diminishes any gains made. Furthermore, to group these sub-definitions under the heading tax havens just adds to the confusion and encourages fragmented research to continue. The term was originally intended to only refer to jurisdictions with tax-related benefits,[106] but over time it evolved to also include jurisdictions that offer far more than tax advantages, some of which are not even related to taxation.[107] It is evident from the OECD's first report on harmful tax practices that the use of the terminology was intended to be limited to tax matters.[108] The first attempt was solely derived based on perceptions of jurisdictions without any objective metrics. The above-mentioned may explain why the term tax haven was widely adopted and is still in use today. The same reasoning can clarify why the term is commonly associated with the OECD's efforts.

If one examines the above criteria, it becomes clear that just because a jurisdiction has no or lower taxes, does not necessarily make it a tax haven. Although low or no taxes do not automatically equate to a tax haven, the OECD uses the no or low taxes criteria to filter suspected jurisdictions. In addition, the no or low taxes are usually aimed at non-residents. Furthermore, the 'no substantial activity requirement' indicates that jurisdictions are attempting to attract investments or primarily tax-focused transactions. This means that even though there is no real value in such investment or transaction, it is merely structured in such a way as to circumvent tax liabilities. Therefore, it equates to no more than paper entries. It should, however, be

[104] R Palan "Tax havens and the commercialization of state sovereignty" (2002) 56 *IO* 151; RS Avi-Yonah "Globalization, tax competition, and the fiscal crisis of the welfare state" (2000) 113 *HLR* 1573; Kudrle & Eden (2003) *SJoLBF* 38.
[105] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 35.
[106] Organisation for Economic Co-operation and Development *International Taxation* (2008). Gordon "Tax havens and their use by United States Taxpayers: An overview. A report to the Commissioner of Internal Revenue the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy)" (12-01-1981) *Department of the Treasury, Internal Revenue Service*.
[107] Cobham, Janský & Meinzer (2015) *EG* 283.
[108] Organisation for Economic Co-operation and Development *International Taxation* (2008).

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noted this last requirement was removed in subsequent OECD reports.[109] To this extent, the substantial requirement was never applied in evaluating jurisdictions.[110] This all changed after the base erosion and profit shifting ("BEPS") project. More specifically, the substance test constituted a crucial part of the BEPS action 5 report.[111] Therefore, the OECD reintroduced the substance requirement to ensure uniformity.[112]

3 3 3 Harmful preferential tax regime

In the original report on harmful tax practices, the OECD has identified the following features to aid the classification of HPTR:[113]

1. no or low effective tax rate
2. "ring fencing" of regimes
3. lack of transparency
4. lack of effective exchange of information.

In addition to the features mentioned above, the OECD has identified and compiled a list of nine supporting factors that can help in the determination of whether a country should be regarded as an HPTR. These features include, but are not limited to:[114]

1. whether the regime encourages purely tax-driven operations or arrangements
2. the artificial definition of the tax base
3. whether foreign source income is exempt from residence country tax
4. a negotiable tax rate or tax base
5. whether the regimes promote themselves as tax minimisation vehicles

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[109] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018) 9.
[110] Organisation for Economic Co-operation and Development *Resumption of Application of Substantial Activities Factor to No or Only Nominal Tax Jurisdictions* (2018) 10.
[111] Organisation for Economic Co-operation and Development *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 -2015 Final Report* (2015) 3.
[112] Organisation for Economic Co-operation and Development *Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions* (2018) 10; OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018) 9.
[113] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).
[114] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998) 26.

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Around the same period, the European union ("EU") undertook a similar investigation into harmful tax regimes in member states and their dependencies. The report identified the following factors that should be considered:[115]

1. Zero or significantly lower effective tax rate than what generally applies in the member state.
2. Such advantages are only reserved for non-residents, or only pertaining to transactions carried out with non-residents.
3. Tax advantages are ring-fenced from the domestic market, to protect the economy and national tax base.
4. Tax advantages are granted regardless of any real economic activity, or substantial economic presents in the member state.
5. Whether the group profit determination rules comply with internationally accepted principles.
6. Are the tax and administrative measures transparent?
7. The effect of the tax regime on other member states.

In subsequent years, the OECD has revised and updated its criteria for what constitutes a HPTR. As discussed above, in the original report, four main features and nine supporting factors were identified.[116] In the updated list, some of the factors were removed, and others were elevated to feature status. This can be regarded as an attempt to create more concise and consolidated assessment criteria. The revised criteria consist of five main features and five additional factors that should be taken into account in the evaluation process. The main features are as follows: [117]

1. no or low effective tax rate on income from geographic mobile financial or other service activities;
2. the regime is ring-fenced from the domestic economy;
3. no transparency;
4. no effective exchange of information; and
5. the regime does not require any substantial activity.

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[115] Council of the European Union "Code of Conduct Group (Business Taxation)" ECOFIN Council on 29 November 1999.
[116] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).
[117] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).

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The supporting factors are as follows:[118]

1. an artificial definition of the tax base;
2. foreign source income exempt from residence country tax;
3. failure to comply with international transfer pricing principles;
4. negotiable tax rate or tax base; and
5. existence of secrecy provisions.

The OECD initially distinguished between tax havens and HPTRs.[119] The former was reserved for mostly non-OECD member states, whose whole or major portion of their economy is structured around facilitating such activities. HPTRs are is aimed at OECD countries, which contain sections or specific tax regimes that are regarded as harmful tax competition, and subsequently violate internationally accepted principles.

To this extent, it is interesting to observe that there are great similarities or overlaps in the original criteria set out for HPTRs and tax havens. For example, the HPTR factor that the regime encourages purely tax-driven operations or arrangements is closely related to the non-substantial activity requirement for tax havens. Furthermore, there is a close link between the first requirement for a tax haven, namely, no or low nominal tax rate, and a number of the additional supporting factors for an HPTR.

With the revised criteria for an HPTR, the OECD decided to do away with the distinction between a tax haven and an HPTR.[120] The same term is now used to refer to any jurisdiction that practises harmful tax competition, regardless of whether it is an OECD member country or non-member country, as long as they satisfy the HPTR criteria. Similarly, there is a strong correlation between The OECD's and the EU's criteria for an HPTR. There is a noticeable overlap between the elements encountered in the OECD's criteria for an HPTR and the standard used by the EU. Besides the fact that the majority of the characteristics form part of both classifications, both definitions also emphasise the low or no tax rates, ring-fenced nature, preference for non-

[118] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).
[119] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).
[120] Organisation for Economic Co-operation and Development *Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions* (2018).

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residents, the lack of transparency, the absence of exchange of information provisions and the limited economic substance requirement.

3 3 4 Offshore financial centre

Defining an OFC is no easy task. The financial stability form ("FSF") attempted to derive a list of elements, which can assist in identifying and classifying an OFC based on the regulatory characteristics of a jurisdiction. The potential features are as follows: [121]

1. no or low taxes on business or investment income;
2. no withholding taxes;
3. relaxed incorporation rules;
4. flexible supervisory regimes;
5. wide application of trusts and other special corporate structures;
6. no need for entities to have a physical presence;
7. impenetrable secrecy laws; and
8. advantages are restricted to non-residents only.

It should be observed, that even though the FSF identified the above list of factors, not all of the OFCs will share all of the aforementioned characteristics. Generally speaking, most large OFCs have well-developed regulatory institutions and comply with international laws on trade and money laundering.[122]

The International Monetary Fund ("IMF") has defined an OFC as: "a centre where the bulk of financial sector activity is offshore on both sides of the balance sheet, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents".[123]

In other words, according to the IMF, an OFC is a jurisdiction that have:[124]

[121] Council of the European Union "Code of Conduct Group (Business Taxation)" ECOFIN Council on 29 November 1999.

[122] T Rixen "Why reregulation after the crisis is feeble: Shadow banking, offshore financial centers, and jurisdictional competition" (2013) 7 *R&G* 436.

[123] International Monetary Fund "Offshore Financial Centres – IMF Background paper" (23-06-2000) *IMF* <https://www.imf.org/external/np/mae/oshore/2000/eng/back.htm> (accessed 28-02-2022).

[124] International Monetary Fund "Offshore Financial Centres – IMF Background paper" (23-06-2000) *IMF*.

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1. large numbers of financial institutions that primarily do business with non-residents;
2. financial systems with external assets and liabilities disproportional to domestic markets;
3. low or zero taxation;
4. moderate or light financial regulation;
5. banking secrecy and anonymity.

It is interesting to note that the IMF distinguishes between OFCs and International Financial Centres. The latter is where the jurisdiction in question does not differentiate between onshore and offshore, funds are received by residents and non-residents alike, and the financial institutions do not separate funds from residents and non-residents.[125] According to Zoromé an OFC can be defined as: "a country or jurisdiction that provides financial services to non-residents on a scale that is incommensurate with the size and the financing of its domestic economy."[126]

The author developed a statistical model to identify OFCs based on economic data. This approach aims to be more objective, unlike regulatory characteristics, which tend to be more subjective in nature. It also strives to remove the political aspect from the equation. However, a big limitation of this approach is the lack of available data. The author attempted to circumvent or minimise this limitation by using other data as a proxy where the primary data is not available.

The model starts by categorising the countries according to their income level in order to establish a base line. Following on the former, it calculates the ratio between net exports of financial services and the country's Gross Domestic Product ("GDP").[127] It is classified as an OFC if the ratio is disproportional to the domestic economy.

Notwithstanding, the latter model is not without criticism. According to the TJN, the model only focuses on OFCs with a large financial services section or the so-called

[125] International Monetary Fund "Offshore Financial Centres – IMF Background paper" (23-06-2000) *IMF*.
[126] A Zomoré "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF* <https://www.imf.org/external/pubs/ft/wp/2007/wp0787.pdf> (accessed 2020-02-28).
[127] Zomoré "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF*.

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private wealth management. Therefore, it fails to account for jurisdictions that specialise in intermediary services that facilitate tax avoidance and other activities.[128]

Fichtner expanded the aforementioned model to also include data on international banking assets, portfolio investment and FDI.[129] This was used to calculate an offshore-intensity ratio.

Unfortunately, the expanded model does not address the original model's limitations, but rather shares the same problem. It has been shown that statistical data is susceptible to political interference and preference.[130] For example, FDI is often under reported.[131] Therefore, even though the more objective and data-driven approach is to be welcomed, there is still room for improvement. By purely relying on the offshore-intensity ratio, it may lead to misleading results. In addition, the model cannot identify the origin of the FDI received.[132] In other words, it is unclear if the FDI originated from one jurisdiction but was routed through another jurisdiction before being received by the country in question.

In an attempt to address the above-mentioned shortcomings, Garcia-Bernardo has developed a novel methodology to more accurately identify and classify OFCs.[133] This approach strives to determine the position of the jurisdiction in the global financial system. By establishing the former, it further distinguishes between sink-OFCs and conduit-OFCs.[134]

Sink-OFCs can be described as jurisdictions which attract and retain FDI.[135] Such jurisdictions are traditionally categorised as tax havens. This includes countries such as the British Virgin Islands, the Cayman Islands and Bermuda, to name a few.[136] These sink-OFCs usually have small domestic economies, but there are exceptions

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[128] Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*.

[129] J Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2928027> (accessed 22-02-2022).

[130] D Mügge & B Stellinga "The unstable core of global finance: Contingent valuation and governance of international accounting standards" (2014) 9 *R&G* 49.

[131] International Monetary Fund *Report on the Measurement of International Capital Flows: Background Papers* (1992).

[132] J Garcia-Bernado, F Takes & E Heemskerk "Uncovering offshore financial centres: conduits and sinks in the global corporate ownership network" (2017) 7 *SR* 2.

[133] 2.

[134] 3.

[135] 3.

[136] 2.

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to the rule. For this reason, the models discussed above are ideally positioned to identify sink-OFCs.[137]

Conduit-OFCs can be described as jurisdictions that facilitate capital transfers or investments.[138] These countries act as the middleman for financial flows before it is routed to other jurisdictions. These jurisdictions play an important role in the global ownership network by enabling the transfer of capital without taxation.[139] This is made possible by a business-friendly regime. The essential feature of such conduit-OFC is the absence of taxes levied on the transfer of capital. This typically takes the form of either interest payments, royalties, dividends or profit repatriation.[140] In addition, such jurisdictions have well-developed legal systems to cater to the needs of big corporations.[141]

Unlike the above-mentioned model,[142] the study by Garcia-Bernardo uses company ownership data and financial flows to determine whether a jurisdiction is an OFC. This method is much more accurate due to the fact that ownership data is already required to be filed with the respective registrars in most jurisdictions.

The study found that most large conduit-OFCs are not small island jurisdictions but, in fact, developed countries.[143] More specifically, these conduit-OFCs are OECD member countries. If the jurisdictions that facilitate and enable harmful tax practices form part of the organisation tasked to curb the trend, it begs the question of whether the OECD is the right body to lead this fight.

Moreover, the study showed that the notion that all OFCs are equal is misplaced. Instead, there are vast specialisations among the OFC offerings.[144] If the converse

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[137] Zomoré "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF*; Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02.
[138] International Monetary Fund "Spillovers in international corporate taxation" (31-12-2016) *IMF* <https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Spillovers-in-International-Corporate-Taxation-PP4873> (accessed 03-03-2022).
[139] Garcia-Bernado, Takes & Heemskerk (2017) *SR* 2.
[140] 2.
[141] 2.
[142] Zomoré "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF*; Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02.
[143] Garcia-Bernado, Takes & Heemskerk (2017) *SR* 2.
[144] 2.

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was true, companies could very easily change jurisdictions as and when regulatory reforms are introduced.

It is noticeable that there is a great overlap between the definitions and characteristics of an OFC, as identified by the FSF and IMF, and that of a tax haven or HPTR, as identified by the TJN, OECD and EU. However, with the ever-increasing focus on OFCs in the global economy, there is significant political influence and controversy surrounding this topic. In addition, numerous authors are of the view, that the term tax haven is being replaced with the term OFC.[145] In some cases, it is even subsumed by the term offshore. This emphasises the position discussed in 3.2.1 above. To this extent, Hampton acknowledges that the operationalisation of tax havens and OFCs, as well as differentiating between them, remains very difficult.[146]

The discoveries made by recent studies highlight some crucial aspects that require further investigation. The establishment that OFCs are specialised opens up new possibilities for more targeted policy reforms.

3 3 5 Secrecy jurisdictions

The TJN has recognised the lack of definitional consistency surrounding the discussion of the offshore finance arena and the resulting adverse consequences that follows.[147] To this extent, the TJN has proposed a new concept to be used instead of the traditional ambiguous and sometimes confusing terminologies such as tax havens, HPTRs and OFCs.[148] This concept is intended to have one universal meaning, with objective criteria and ascertainable parameters. In addition, the aim is to eliminate political interference and bias, which often occur when addressing this topic. Following the former, the TJN has coined the term secrecy jurisdiction.[149]

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[145] Johns *Tax Havens and Offshore Finance* 49; Cobb (1998) *Geoforum* 11; Hudson "Offshore onshore: Re-Shaping the financial regulatory landscape" in *Money and the Space Economy* 139-145; Hudson (2000) *TotloBG* 269; Roberts "Fictitious capital, fictitious spaces: The geography of offshore financial flows" in *Money, Power and Space* 91-115; Maurer (2008) *Geography Compass* 165.

[146] Hampton *The Offshore Interface: Tax Havens in the Global Economy* 79.

[147] Tax Justice Network "Financial Secrecy Index" <https://fsi.taxjustice.net/en/> (accessed 04-03-2022).

[147] Garcia-Bernado, Takes & Heemskerk (2017) *SR* 2.

[148] Cobham, Janský & Meinzer (2015) *EG* 283; The Economist "Storm survivors" (14-02-2013) *The Economist*.

[149] RA Murphy "Finding the Secrecy World – rethinking the language of offshore" (undated) *Tax Research* <http://www.taxresearch.org.uk/Documents/Finding.pdf> (accessed 04-03-2022).

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A secrecy jurisdiction can be described as a country that: "provides facilities that enable people or entities to escape or undermine the laws, rules and regulations of other jurisdictions elsewhere, using secrecy as a prime tool".[150]

In other words, a secrecy jurisdiction has the following characteristics:[151]

1. Its regulations and legislation are aimed at benefiting non-residents.
2. It has a deliberate secrecy framework endorsed and supported by the legal system, with the primary goal of concealing the identities and activities of those who use the services.

The Financial Secrecy Index ("FSI") ranks countries according to the level of secrecy provisions and their impact propensity.[152] The FSI is a comprehensive list featuring all countries in the world, regardless of whether they have ironclad secrecy mechanisms or no secrecy provisions whatsoever.

This eliminates the strict compliance problem. In other words, with traditional definitions, a country either fits the classification or it does not. In such a construct, there is no provision for something in between. This all-or-nothing approach is very problematic, especially when dealing with such a complex matter as offshore finance. Even though there are criteria and supporting factors to consider in the determination process, it is possible that a jurisdiction can fall outside the definition if there is a slight deviation from the list. Therefore, the sliding scale methodology addresses this limitation.

The FSI uses similar data as the studies by Zoromé and Fichtner,[153] but supplements the former by quantifying the degree and scope of secrecy mechanisms available. This data is then used to calculate an FSI score. This score gauges the level of opaqueness of the specific country or jurisdiction.[154]

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[150] M Meinzer "Where to draw the line? Identifying secrecy jurisdictions for applied research" (2011) *White Paper on the FSI 2011* <http://taxjustice.blogspot.com/2012/10/new-white-paper-on-fsi-2011-where-to.html> (accessed 04-03-2022).
[151] Murphy "Finding the Secrecy World – rethinking the language of offshore" (undated) *Tax Research*.
[152] Cobham, Janský & Meinzer (2015) *EG* 287.
[153] Zomoré "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF*; Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02.
[154] Cobham, Janský & Meinzer (2015) *EG* 287.

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The secrecy component of the FSI score consists of fifteen indicators, which can be categorised as follows:[155]

1. knowledge of beneficial ownership;
2. corporate transparency;
3. efficiency of tax and financial regulation; and
4. international standards and co-operation.

The second portion of the FSI comprises the global scale weight ("GSW"). This score is calculated by taking a jurisdiction's net financial services exports as a ratio to the total global financial services rendered.[156] This is in contrast to the studies by Zoromé and Fichtner,[157] where the ratio to the country's GDP was used. This latter approach gives one a much more accurate indication of such jurisdiction's market share and, therefore, its influence in the global finance network.

Upon an analysis of the FSI results, it reveals the extent of developed countries' influence on global finance services.[158] However, it should be noted that just because a country has a big market share does not necessarily mean that it has equally strong secrecy provisions. As long as such jurisdiction has adequate transparency safeguards in place, it poses no or little risk to the world. In such a case, the jurisdiction will have a lower FSI ranking. The converse is also true; some small countries have impenetrable secrecy frameworks but such a low GSW that it is almost insignificant. This is a departure from the traditional view that small island countries are the true culprits.[159] For any intervention to successfully curb harmful tax practices and other

[155] 287.
[156] Reuter P *Draining Development? Controlling Flows of Illicit Funds from Developing Countries* (2012) 346.
[157] Zoromé "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF*; Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02.
[158] Tax Justice Network "Financial Secrecy Index 2020 reports progress on global transparency – but backsliding from US, Cayman and UK prompts call for sanctions" (18-02-2020) *Tax Justice Network* <https://www.taxjustice.net/2020/02/18/financial-secrecy-index-2020-reports-progress-on-global-transparency-but-backsliding-from-us-cayman-and-uk-prompts-call-for-sanctions/> (accessed 05-03-2022).
[159] Cobham, Janský & Meinzer (2015) *EG* 290.

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elicit activities, the buy-in from developed countries such as the OECD members is paramount.[160]

It is submitted that the concept of a secrecy jurisdiction is a welcomed development. It departs from the typical narrow and superficial focus on mere tax rates. Instead, it addresses the root of the problem: the lack of transparency.[161]

It should be remembered that mere tax competition *per se* is not necessarily problematic; only if it starts to adversely impact other jurisdictions' tax base does it become problematic.[162] In addition, many of these havens offer much more than only tax benefits. Instead, it enables the circumvention of regulations and laws.[163] The common thread across all the terminologies surrounding global finance, is the lack of exchange of information and transparency provisions. It is, therefore, more appropriate to emphasise the secrecy level.

3 3 6 Mauritius

If one applies the above-mentioned criteria, for each of the terms, it becomes quite clear how subtle and technical the difference really is, and the large overlap that exist among the classifications. Therefore, it is unsurprising that the use of these terms is often very ambiguous.

3 3 6 1 Offshore

Regardless of the interpretation or definition one applies, Mauritius will satisfy the criteria in the majority of cases. Once again, what exactly the term will mean depends on the context in which it is used. The Merriam-Webster dictionary's meaning refers to a foreign country,[164] while the Collins dictionary emphasises the tax treatment and

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[160] Tax Justice Network "Financial Secrecy Index 2020 reports progress on global transparency – but backsliding from US, Cayman and UK prompts call for sanctions" (18-02-2020) *Tax Justice Network*.

[161] Gordon "Tax havens and their use by United States Taxpayers: An overview. A report to the Commissioner of Internal Revenue the Assistant Attorney General (Tax Division) and the Assistant Secretary of the Treasury (Tax Policy)" (12-01-1981) *Department of the Treasury, Internal Revenue Service*.

[162] Organisation for Economic Co-operation and Development *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 -2015 Final Report* (2015).

[163] Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*; Cobham, Janský & Meinzer (2015) *EG* 291.

[164] Merriam-Webster "Offshore" <https://www.merriam-webster.com/dictionary/offshore> (accessed 2020-02-18).

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geographic location of the jurisdiction. [165] If one takes the perspective from outside Mauritius, both descriptions are true. If one uses the term offshore as an umbrella term or a synonym for tax havens,[166] the former will also encapsulate Mauritius. This will, however, depend on one's connotation and understanding of the term tax haven.

It is possible to limit the wide reach by restricting the use to a subset of economic trade.[167] For example, to only include jurisdictions which have low regulation, low taxation, or strong secrecy provisions. If this interpretation is to be preferred, Mauritius will once again fulfil the criteria. [168]

The definition put forward by Hampton,[169] and supported by Palan also focuses on the geographic location, but emphasises the reach of regulatory powers.[170] Even though Mauritius is an island, this is not the determining factor. The emphasis rather falls on the regulatory framework. Instead of using a binary definition, it might be more sensible to regard the term offshore as a matter of degree.[171] This will broaden the ambit but will place the country on a spectrum similar to the FSI score. Given the correlation with the term tax haven, Mauritius will most likely place fairly high on the list. This is a result of the investor-friendly framework. A comparable conclusion will be reached if Zucman's list of characteristics is applied.

Wojcik's definition focuses heavily on the place of registration or incorporation.[172] This is based on the expert agreement approach.[173] It also emphasises the use and promotion of certain entity types, such as shell companies, trusts, special purpose

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[165] Collins Dictionary "Offshore" <https://www.collinsdictionary.com/dictionary/english/offshore> (accessed 2020-02-18).

[166] Cobb (1998) *Geoforum* 11; Hudson "Offshore onshore: Re-Shaping the financial regulatory landscape" in *Money and the Space Economy* 139-145; Hudson (2000) *TotloBG* 269; Roberts "Fictitious capital, fictitious spaces: The geography of offshore financial flows" in *Money, Power and Space* 91-115; Maurer (2008) *Geography Compass* 165.

[167] Wainright "Emerging onshore-offshore industries: The case of asset-backed securities markets in Europe" (07-08-2013) *Oxford University*.

[168] Mauritius Attractions "The geography of Mauritius" (undated) *Mauritius Attractions*; Tax Justice Network "Narrative report on Mauritius" (undated) *Tax Justice Network*.

[169] Hampton *The Offshore Interface: Tax Havens in the Global Economy* 87.

[170] Palan (1998) *International Studies Quarterly* 631.

[171] Wojcik "Accounting for globalization: Evaluating the effectiveness of country-by-country reporting" (2012) *Employment, Work and Finance Working Paper* 12-08, 5.

[172] Wojcik "Accounting for globalization: Evaluating the effectiveness of country-by-country reporting" (2012) *Employment, Work and Finance Working Paper* 12-08 5.

[173] Haberly & Wojcik (2014) *JoEG* 79.

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vehicles, and mutual funds. If the former is followed, Mauritius will be regarded as offshore. Mauritius has a well-developed offshore trust and company regime.[174]

3 3 6 2 Tax haven

As with the term "offshore", the term tax haven has different meanings to different people. If one starts with the dictionary meaning, it is noticeable how similar the Cambridge English Dictionary and the Oxford Advanced Learner's Dictionary define a tax haven.[175] Both emphasise the low or non-taxes. This coincides with the view of economists. Based on this benchmark, Mauritius will definitely classify as a tax haven.[176] One will reach a similar conclusion if one applies the TJN's tax haven criteria to Mauritius. Many of the attributes that make Mauritius an attractive investment destination[177] are also regarded as elements of tax havens. The TJN regards Mauritius as one of the worst tax havens, especially for African countries.[178]

The OECD identified Mauritius as a tax haven, and it was earmarked for the black list.[179] Mauritius, however, agreed to cooperate with the OECD initiative.[180] After implementing the minimum requirements, Mauritius was placed on the white list.[181] In subsequent years, Mauritius was repeatedly flagged as a tax haven, and various

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174 Offshore Trusts Guide "Offshore trusts report: Mauritius" (undated) *Offshore Trust Guide* <https://www.offshoretrustsguide.com/report/mauritius_tax_treatment.asp> (accessed 10-03-2022); LC Verbist "Mauritius: Offshore trusts in Mauritius" (10-03-2008) *Mondaq* <https://www.mondaq.com/trusts/58110/offshore-trusts-in-mauritius> (accessed 10-03-2022).

175 Cambridge Dictionary "Tax Haven" <https://dictionary.cambridge.org/dictionary/english/tax-haven> (accessed 2020-02-22); Oxford Learner's Dictionary "Tax haven" <https://www.oxfordlearnersdictionaries.com/definition/english/tax-haven> (accessed 2020-02-22).

176 Monarch & Co "Benefits of investing" <http://monarchandco.com/mauritius/business/benefits-of-investing/> (accessed 10-03-2022).

177 Africa Wealth Report "The AfrAsia Bank Africa Wealth Report 2019" (2019) *Afrasia Bank* <https://www.afrasiabank.com/en/about/newsroom/africa-wealth-report-2019> (accessed 10-03-2022).

178 R Etter-Phoya "The UAE and Mauritius are the most corrosive corporate tax havens against African countries – Tax Justice Network Africa" (30-05-2019) *Tax Justice Network* <https://www.taxjustice.net/2019/05/30/the-uae-and-mauritius-are-the-most-corrosive-corporate-tax-havens-against-african-countries-tax-justice-network-africa/> (accessed 10-03-2022).

179 Financial Stability Forum "Report of the Working Groups on Offshore Centres" (05-04-2000) *FSB* <https://www.fsb.org/wp-content/uploads/r_0004b.pdf> (accessed 11-03-2022).

180 Etter-Phoya "The UAE and Mauritius are the most corrosive corporate tax havens against African countries – Tax Justice Network Africa" (30-05-2019) *Tax Justice Network*.

181 Organisation for Economic Co-operation and Development *Tax Co-operation 2009: Towards a Level Playing Field – 2009 Assessment by the Global Forum on Transparency and Exchange of Information* (2009).

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organisations severely criticised the OECD's measures.[182] Recently, the EU has agreed to remove Mauritius from their black list.[183]

3 3 6 3 Harmful preferential tax regimes

As discussed in 3.2.3, the OECD did away with the distinction of tax havens and HPTRs.[184] They rather consolidated the criteria and the conclusion of the application to Mauritius will be the same as that reached under the tax haven analysis.

3 3 6 4 Offshore financial centre

If one shifts the analysis to OFCs, one will notice the large similarity and overlap with the tax haven determination. If one uses the FSF list of characteristics as a point of departure,[185] it becomes clear that Mauritius has the majority of the features.[186] The same result will be reached when the IMF's criteria is applied.[187] It is important to note these are based on the regulatory framework of a jurisdiction.

If one examines the economic data, the studies by Zoromé and Fichtner serve as a good point of departure.[188] Zoromé determined that Mauritius is an OFC. Regardless that some information was unavailable, there was still overwhelming evidence for this determination.[189] Fichtner used a similar method than Zoromé but

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[182] How an idyllic African island became a tax haven for some of the world's biggest corporations" (23-07-2019) *Quartz*; Hein "Mauritius: a brief history of business laws in Mauritius since 1968" (18-03-2018) *Mondaq*.

[183] F Guarascio "EU removes UAE, Switzerland, Mauritius from tax haven lists" (10-10-2019) *Reuters* <https://www.reuters.com/article/us-eu-taxation-blacklist/eu-removes-uae-switzerland-mauritius-from-tax-haven-lists-idUSKBN1WP0SP> (accessed 10-03-2022).

[184] Organisation for Economic Co-operation and Development *Resumption of Application of Substantial Activities Factor to No or Only Nominal Tax Jurisdictions* (2018).

[185] Financial Stability Forum "Report of the Working Groups on Offshore Centres" (05-04-2000) *FSB*.

[186] Monarch & Co "Benefits of investing" (undated) *Monarch & Co* <http://monarchandco.com/mauritius/business/benefits-of-investing/> (accessed 12-03-2022); Financial Times "Special Report: Investigating Mauritius" <https://www.ft.com/reports/investing-mauritius> (accessed 2020-03-12).

[187] International Monetary Fund "Offshore Financial Centres – IMF Background paper" (23-06-2000) *IMF*.

[188] Zomoré "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF*; Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02.

[189] Zomoré "Concept of offshore financial centres: in search of an operational definition" (2007) *IMF*.

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included a wider range of data.[190] This was used to calculate an offshore-intensity ratio. This ratio can then be compared against the global average of 1,27. Jurisdictions with a ratio of five times or more, are most likely to be an OFC. If this is applied to Mauritius, it confirms the finding by Zoromé, that Mauritius is an OFC, with a ratio of 14,3 and an overall ranking of 12.[191]

Garcia-Bernardo sought to improve the accuracy and address some of the shortcomings of Zoromé and Fichtner's approach. Global ownership data was therefore used to identify the position of a jurisdiction within the larger financial network.[192] This also allowed for the classification of OFCs and even subcategories of OFCs. A distinction was made between sink-OFCs and conduit-OFCs.[193] If one applies this to Mauritius, it is regarded as an OFC. More specifically, it is considered a sink-OFC, meaning that it not only attracts high amounts of FDI, but also retains it.

3 3 6 5 Secrecy jurisdiction

Mauritius has a FSI score of 45, with a GSW of 1,72%.[194] This demonstrates that Mauritius is a moderate secret jurisdiction, with only a tiny global offshore industry market share. This gives Mauritius a ranking of 51 out of 133 countries.[195] Despite the double tax agreements ("DTA") and exchange of information agreements concluded, it is still within the top 40% of secret jurisdictions.

Notwithstanding the various interpretations and definitions, for purposes of this study, the general term "tax haven" will be used in subsequent sections and chapters. This will collectively include HPTRs, OFCs and secrecy jurisdictions. These terms may be used interchangeably unless the context clearly intends otherwise. This does not detract from the importance of clearly defined and separate definitions, but it is done to maintain simplicity. This will allow the section or chapter to focus on achieving the objective rather than getting side-tracked in the classification exercise. It should be noted that the distinctions are very technical in nature, and no consensus currently

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[190] Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02.
[191] Fitchner "The Offshore-Intensity Ratio: Identifying the strongest magnets for foreign capital" (2015) *CITYPERC Working Paper Series* 2015/02.
[192] Garcia-Bernado, Takes & Heemskerk (2017) *SR* 3.
[193] 3.
[194] Tax Justice Network "Narrative report on Mauritius" (undated) *Tax Justice Network*.
[195] Tax Justice Network "Narrative report on Mauritius" (undated) *Tax Justice Network*.

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exists regarding the ambit and boundaries of the different terminologies. Regardless of this fact, it is still imperative to explain and understand the differences between the aforementioned terms. In order to thoroughly comprehend the complexity and extent of this topic and to appreciate the significance of the recent developments and debates, it is crucial to have a comprehensive understanding of the various definitions used and their deficiencies.

3 4 Why are there tax havens?

Before examining which countries become tax havens and under what circumstances, it is worthwhile to briefly explore why tax havens exist. Are tax havens really parasitical and opportunistic jurisdictions only driven by greed and self-interest, with no regard for the well-being of other countries? Or are they rather the result of the underlying principles on which international tax policies are based?

Understanding why tax havens exist or what creates the enabling framework can aid in more accurately evaluating the measures taken by the OECD and other organisations to curb the surge. In addition, it may present novel solutions. This question is complex and may entail multiple aspects. A detailed analysis of the framework and measures falls outside the scope of this dissertation. Yet a brief discussion of some of the reasons for the existence of tax havens will be included.

The initial response may be that it is an exceedingly obvious question—tax havens exist because countries use their tax laws to attract business, either to increase economic growth or maximise tax revenue, or both.[196] Unfortunately, according to the literature, it is not that simple.

There are conflicting views on whether a jurisdiction can use taxation as a means to compete with other countries over business investment. If this is adopted in isolation, it generally does not benefit a country's long-term economic growth. This is because competition leads to a "race to the bottom" compared to a world without competition where investment would be made anyway.[197] In this regard, taxation has been shown to be an important factor for investors and a perfect opportunity for

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[196] E Janeba "Corporate income tax competition, double taxation treaties, and foreign direct investment" (1995) 56 *JoPE* 312.
[197] Avi-Yonah (2000) *HLR* 1573; A Nov "The "bidding war" to attract foreign direct investment: the need for a global solution" (2006) *VTR.*

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countries to increase FDI if used correctly. [198] Furthermore, tax havens generally have not adopted revenue-maximising rates or engaged in theoretically revenue-maximising behaviour.[199]

If one accepts the aforementioned views that there are no long-term economic and fiscal benefits for tax havens to exist, it begs the question of whether tax havens are acting irrationally and contrary to their own interests. Alternatively, are tax havens perhaps captured by special interest groups, which are apathetic to the harms they are imposing on the world, or is some other underlying phenomenon at play? [200]

Following from the latter, there is a notion that the fundamental policy superstructure of the international tax laws of developed countries can actually create or exacerbate all or part of the incentives necessary for countries to act as tax havens.[201] This is a result of the big focus placed on "capital neutrality". In essence, minimising double taxation on cross-border business and investment —can itself create the environment for other countries to engage in tax competition.

In order to comprehend the aforementioned, it is necessary to explore the concept of capital neutrality briefly. The rationale behind the former is primarily to mitigate double taxation. In other words, the situation where two countries are imposing a tax on the same item of income.

If double taxation can be avoided, capital will more easily cross borders, increasing gains from trade and making every country better off.[202] This is, however, not a perfect solution. Apart from the benefits, making capital more mobile can also have a disadvantage.

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[198] MA Desai "Chains of ownership, tax competition, and the location decisions of multinational firms" in H Herrmann & R Lipsey (eds) *Foreign Direct Investment in the Real and Financial Sector of Industrial Countries* (2003) 63; R Altshuler "Has U.S. investment abroad become more sensitive to tax rates?" in JR Hines Jr. (ed) *International Taxation and Multinational Activity* (2001) 15; Altshuler R & Grubert H "Taxpayer responses to competitive tax policies and tax policy responses to competitive taxpayers: recent evidence" (2004) 34 *TNI* 1351.

[199] JR Hines Jr. & EM Rice "*Fiscal* p*aradise: Foreign* tax havens and *American* b*usiness*" *(1994)* 109 *QJ Econ* 149.

[200] M Singh "Tax havens: all you need to know" (19-07-2022) *Investopedia* <https://www.investopedia.com/articles/tax/09/tax-havens.asp> (accessed 23-03-2022).

[201] Singh "Tax havens: all you need to know" (19-07-2022) *Investopedia*.

[202] Janeba (1995) *JoPE* 312.

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The more mobile capital becomes, the easier countries can use tax incentives to attract capital.[203] This means that each country which focuses on double taxation relief may make tax competition a cheaper and more viable option for other countries to attract capital.[204]

This gives rise to the so-called "capital neutrality paradox".[205] In other words, the pursuit of capital neutrality by developed countries is intended to increase worldwide efficiency—which could lead to greater incentives for other countries to engage in tax competition. This fertile environment for tax competition has the opposite effect, effectively undermining worldwide efficiency.

This does not mean that the costs of capital neutrality will outweigh the benefits or that all countries will act on the incentive to engage in tax competition. Rather, it means that the opportunity to do so exists.

Notwithstanding the aforementioned, if, for all countries involved, the benefits of capital mobility always outweighed the benefits derived from tax competition, the opportunities created by the capital neutrality paradox would be irrelevant.[206] This implies that some countries will benefit more from tax competition than gains from trade.

This idea challenges the assumptions underlying the modern international tax regime: that capital will flow to its highest and best use unless the tax law somehow prevents it from doing so. Contrary to the former, the empirical evidence consistently demonstrates precisely the opposite.[207] Developing countries attract disproportionately lower amounts of capital than predicted under any version of neoclassical economic theory.[208] This is known as the "Lucas Paradox".[209]

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[203] DM Ring "Who is making international tax policy? International organizations as power players in a high stakes world" (2010) 249 *FILJ* 702.

[204] M Leibrecht & T Rixen "Double Tax Avoidance and Tax Competition for Mobile Capital" in M Zagler (ed) (2010) *International Tax Coordination. An Interdisciplinary Perspective on Virtues and Pitfalls* 65.

[205] R Lopez, PC Gutiérrez & E Figueroa E "The tax paradox and weak tax neutrality" (2020) 86 *SEJ* 1152.

[206] 1153.

[207] L Alfaro, S Kalemli-Ozcan & V Volosovych "Why doesn't capital flow from rich to poor countries? An empirical investigation" (2008) 90 *RE&S* 347.

[208] D Cohen & M Soto "Why are poor countries poor? A message of hope which involves the resolution of a Becker/Lucas Paradox" (2002) Centre for Economic Policy Research, Discussion Paper No 3528. MA Clemens & JG Williamson "Where did British foreign capital go? Fundamentals, failures, and the Lucas Paradox: 18701913" (2000) Nat'l Bureau of Econ. Research, Working Paper 8028.

[209] RE Lucas Jr "Why Doesn't Capital Flow from Rich to Poor Countries?" (1990) 80 *Am Econ Rev.* 92.

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According to some authors, it is more of a puzzle than a paradox[210] because not only does capital fail to flow to developing countries as expected, but it also flows in the wrong direction.[211] In other words, it flows from developing countries to developed countries.

According to Montiel, there are a number of possible reasons to explain this phenomenon — why capital does not flow from rich to poor countries.[212] This includes lower productivity, lower human capital, information frictions, and low levels of domestic financial development.[213]

This suggests that in the absence of tax competition, capital flows for poorer countries will almost always be insufficient to provide an adequate tax base to satisfy any definition of minimal revenue needs through their tax systems.[214] Although wealthier countries' adoption of capital neutrality does not cause the lack of tax base in poorer countries, it indirectly provides a powerful tool for these countries to attract otherwise unavailable capital.

The value of the aforementioned concepts does not lie in the notion that tax competition may be an inevitable part of the international tax regime.[215] Rather, the perceived problems of tax competition should not be viewed as isolated incidents of taxpayers exploiting loopholes or poorer countries acting irrationally. Instead, it should be viewed as part of a larger set of disparate incentives for capital to locate in wealthier as opposed to poorer countries.[216]

It should be observed that a country does not become a tax haven solely due to the incentives of the capital neutrality paradox, nor could all countries which might desire to engage in tax competition successfully do so. Instead, the capital neutrality

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[210] Gourinchas P-O & Jeanne O "Capital Flows to Developing Countries: The Allocation Puzzle" (2002) *Nat'l Bureau of Econ. Research, Working Paper* 13602.

[211] J Ju & S-J Wei "*A Solution to Two Paradoxes of International Capital Flows*" (2006) *Nat'l Bureau of Econ. Research, Working Paper No. 12668*.

[212] Montiel PJ "Obstacles to investment in Africa: explaining the Lucas Paradox" (2006) paper presented at the *Realizing the Potential for Profitable Investment in Africa* 3.

[213] 30.

[214] Singh "Tax havens: all you need to know" (19-07-2022) *Investopedia*.

[215] JA Roin "Can income from capital be taxed? An international perspective" in HJ Arnold (eds) *Taxing Capital Income* (2007) 211; RE Baldwin & P Krugman "*Agglomeration, Integration, and Tax Harmonisation" (2004)* 48 *EE Rev* 1; S Krogstrup "*Standard Tax Competition and Increasing Returns" (2008)* 10 *JEPT* 547.

[216] Alfaro L, Kalemli-Ozcan S & Volosovych V "Why doesn't capital flow from rich to poor countries? An empirical investigation" (2008) 90 *RE&S* 347.

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paradox provides for incentives in the international tax regime for certain countries to engage rationally in tax competition, which have so far been underappreciated in the literature.[217] Only once these incentives are taken into account will it be possible to formulate effective solutions.[218]

3 5 Becoming a tax haven

It is well known that tax havens have positioned themselves in such a way as to attract large amounts of foreign business and FDI.[219] Over time, tax havens accumulated substantial wealth, which enabled rapid economic growth.[220] In many cases, they outperform the rest of the world, regardless of external circumstances. Therefore, it is unsurprising that many countries may try to emulate this success by adopting offshore finance and related services as their developmental strategy. It, therefore, begs the question, which countries can become tax havens and why?

If a country wishes to embark on this journey, it may require some difficult and unpopular decisions. Notwithstanding the lucrative nature, the aforementioned may explain why there are only around 40 tax havens in the world.[221]

In order to succeed with the former, the jurisdiction must become an attractive investment destination.[222] Such a country will have to adopt business-friendly policies. This includes but is not limited to attractive tax rates.[223] The latter is especially applicable to non-residents. Tax havens attract FDI because income earned locally is taxed at favourable rates and because tax haven activities facilitate the avoidance of

[217] Leibrecht M & Rixen T "Double Tax Avoidance and Tax Competition for Mobile Capital" in M Zagler (ed) (2010) *International Tax Coordination. An Interdisciplinary Perspective on Virtues and Pitfalls* 73.
[218] Singh "Tax havens: all you need to know" (19-07-2022) *Investopedia*.
[219] Schultz A "Why Asia's rich really use global tax havens" <https://www.barrons.com/articles/why-asias-rich-really-use-global-tax-havens-1460420954> (accessed 2020-03-25).
[220] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 182.
Hines Jr JR "Do tax havens flourish?" in JM Poterba (ed) *Tax policy and the Economy* (2005) (vol 19) 67.
[221] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 190.
[222] Desai "Chains of ownership, tax competition and the location of multinational firms" in *Foreign Direct Investments in the Real and Financial Sector of Industrial Countries* 62.
[223] Hines Jr JR "Tax policy and the activities of multinational corporations" in AJ Auerbach (ed) *Lessons from Economic Research* (1997) 401.
Hines Jr JR "Lessons from behavioural responses to international taxation" (1999) 52 *NTJ* 306.
Gordon RH & Hines Jr JR "International taxation" in AJ Auerbach & M Feldstein *Handbook of Public Economics Vol 4* (2002) 1395.
Devereux MP "The impact of taxation on the location of capital, firms and profit: a survey of empirical evidence" (2007) *Oxford University Centre for Business Taxation Working Paper 07/02*.

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taxes that might otherwise have to be paid to other countries.[224] It is important to observe that other factors also influence a country's tax regime.[225]

Besides no or very low taxes on personal and corporate income, these jurisdictions typically incorporate some or all of the following elements.[226] Often there are no dividend taxes. Similarly, residents are not liable for any donation or gift taxes. This is also the case for estate duty or inheritance taxes. Furthermore, there is no or limited stamp duty or transfer duty payable on the change of ownership for shares or property. Closely related, there is no capital gains tax. Other forms of indirect taxation are also limited. Sales tax or value-added tax ("VAT") is usually low or in line with the global average. It is important to note the offerings may vary based on the jurisdiction.

In addition, the tax regime enables tax havens to facilitate investments.[227] This is made possible by the limited taxes on capital. This drastically reduces the cost of moving capital between countries. The robust financial services sector further enhances this.[228] Due to the nature and reliance on financial services, these jurisdictions attract experts in their fields.[229]

The majority of tax haven jurisdictions also feature high on the rankings in terms of the ease of doing business.[230] This business-friendly environment, coupled with the tax treatment, is a compelling factor for many. Closely related is the light touch regulatory approach.[231] This means there are much fewer administrative burdens and bureaucratic processes to comply with.[232] The efficiency and turnaround times are also greatly enhanced.

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[224] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1060.
[225] Hines Jr JR "Corporate taxation and international competition" in AJ Auerbach et al (eds) *Taxing corporate income in the 21st century* (2007).
Keen M & Wildasin D "Pareto-efficient international taxation" (2004) 94 *AER* 261.
[226] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 190. Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World* 9.
[227] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1060.
[228] 1067.
[229] Deloitte "Tax havens and the game of hide and seek" <https://www2.deloitte.com/za/en/pages/tax/articles/tax-havens-and-legitimate-planning.html> (accessed 2020-03-27).
[230] World Bank Group "Doing Business 2020: Comparing business regulation in 190 economies" (2020) *WorldBank*; Schwab "The Global Competitiveness Report 2019" (2019) *World Economic Forum*.
[231] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 168.
[232] Deloitte "Tax havens and the game of hide and seek" <https://www2.deloitte.com/za/en/pages/tax/articles/tax-havens-and-legitimate-planning.html> (accessed 2020-03-27).

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The decision to implement such policies may face tremendous budgetary and political opposition. It may contradict the government's political ideologies or undermine the implementation of populist projects and policies.

During the transition phase, countries may experience budgetary shocks. This can result from the loss of revenue, which was previously generated from the taxation on businesses and high-wealth individuals. Consequently, it may be necessary to increase indirect taxes to compensate for the former.[233] Such unpopular decisions will require significant political capital to implement successfully.

Based on the classic argument from Diamond,[234] Gordon held that governments with a sufficient number of available tax instruments could make all domestic residents better off by not taxing internationally mobile capital.[235] The reason for the former stems from the idea that small open economies are inevitably price-takers in the global market. Such jurisdictions are unable to shift their tax burden onto foreign investors. Therefore, these countries are not incentivised to tax foreign investors since doing so simply distorts their economies without returning any benefit. [236]

It may therefore be more harmful to small countries to rely on taxing non-residents than the advantages derived. This is because the domestic market ultimately bears the costs of taxing foreigners. It typically manifests in, for example, lower wages and property prices.[237] In addition, the diminishing returns do not validate the resources required to collect these taxes. For this reason, domestic residents would be better off if the government in question removed any taxes on foreign investors and directly taxed the returns in the local market.

Notwithstanding the above, countries that become tax havens generally experience an increase in revenue.[238] This is despite the business-friendly tax regime. The latter is attributed to the expanded tax base and subsequent economic growth.

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[233] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1067.

[234] Diamond P & Mirrlees J "Optimal taxation and public production, I: Production efficiency; II: Tax rules" (1971) 61 *AER* 264.

[235] Gordon RH "Taxation of investment and savings in a world economy" (1986) 76 *AER* 1086.

[236] 1086.

[237] 1087.

[238] Desai "Chains of ownership, tax competition and the location of multinational firms" in *Foreign Direct Investments in the Real and Financial Sector of Industrial Countries* 63.
Altshuler R "Has U.S. investment abroad become more sensitive to tax rates?" in JR Hines Jr. (ed). *International Taxation and Multinational Activity* (2001) 15.
Altshuler R & Grubert H "Taxpayer responses to competitive tax policies and tax policy responses to competitive taxpayers: recent evidence" (2004) 34 *TNI* 1351.

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3 5 1 Associated characteristics

Countries with the following characteristics are more likely to succeed in becoming tax havens: [239]

1. small population;
2. geographic size; and
3. good governance.

In addition, the following factors have been identified to have a positive correlation with tax haven status: [240]

1. economic openness;
2. the use of the parliamentarian system; a
3. a common-law-based legal system;
4. English competency;
5. advance telecommunication infrastructure; and
6. limited natural resources.

3 5 2 Quality of governance

In order to determine a jurisdiction's quality of governance, the following elements are important:[241]

1. accountability;
2. political stability;
3. government effectiveness;
4. the rule of law; and
5. control of corruption.

[239] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 *JoPE* 1062.
[240] 1063.
[241] D Kaufmann, A Kraay & M Mastruzzi "Governance matters IV: Governance indicators for 1996-2004" (2005) *World Bank Working Paper.*
François R "Why should world governance be evaluated and for what purpose?" <https://www2.world-governance.org/IMG/pdf_WGI_full_version_EN.pdf> (accessed 2020-03-28).

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Data suggests that geographic characteristics and governance quality are the most noteworthy determinants for successfully becoming a tax haven.[242] Countries with fewer people and a smaller geographic footprint are significantly more likely to become tax havens.[243] Furthermore, a strong link exists between well-governed jurisdictions and those countries that become tax havens. This is evident from the outcome of the regression framework that controls for other observable variables. The association of good governance with the likelihood of being a tax haven is both statistically significant and quantitatively very large.[244] The link between good governance and becoming a tax haven may be attributed to the notion that it is more beneficial for a well-governed country to become a tax haven compared to the returns for poorer countries. This may be due to the higher foreign investment flows they attract and the subsequent economic benefits.

The preceding discussion suggests that reduced tax rates and attractive tax attributes are not enough on their own for countries to entice investors. It must coincide with an all-around well-governed state. Investors require confidence in the country and the reassurance that their assets are safe.

This means that poorly governed countries do not relinquish any economic benefit by not becoming tax havens. This is because such a developmental strategy is not feasible nor suitable for their circumstances.

In addition, there are signs that measures of past governance quality are associated with being a tax haven.[245] This implies that not only the current state of affairs, but also the long-term stability of a jurisdiction is paramount for investors. Moreover, jurisdictions with a proven track record are preferred. Therefore, it is also unclear how new entrants into this market will be regarded.

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[242] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 *JoPE* 1061.
[243] Kanbur R & Keen M "*Jeux Sans Frontieres:* tax coordination when countries differ in size" (1993) 83 *AER* 879.
Hansen NA & Kessler AS "The political geography of tax h(e)avens and tax hells" (2001) 91 *AER* 1105.
[244] Dharampala & Hines Jr (2009) *JoPE* 1062.
[245] 1062.

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3 5 3 Mauritius

The island country of Mauritius has a small geographic footprint, extending 2040km^2 in size,[246] of which Mauritius has an area of 1860km^2.[247] The rest of the area is made up of small surrounding islands, which are dependencies of the Republic. It has a population of 1.27 million people,[248] with an above-average life expectancy of 70 and 75 years for males and females, respectively.[249] The official language of the Republic is English, with a range of other recognised languages.[250] The Mauritian legal system originated from the English common law,[251] with a strong French civil law influence.[252] The Mauritian constitution is the supreme law of the country.[253]

Mauritius has a well-developed and competitive political system.[254] It follows a parliamentarian system, with a president as the head of state.[255] The executive power is, however, vested with the prime minister.

Aside from the natural beauty, Mauritius does not have many natural resources. Mining activities are limited to basalt and lime.[256] The agriculture sector mainly consists of sugarcane production and subsistence crops. The economic reliance on agriculture has diminished over the years but still contributes meaningfully to GDP,[257] and an important resource for Mauritius is its ocean economy.[258]

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[246] Bowman LW "Mauritius" <https://www.britannica.com/place/Mauritius> (accessed 2020-03-28).
[247] Nations Encyclopaedia "Mauritius – location, size and extent" (2023) *Nations Encyclopaedia*.
[248] Worldometer "Mauritius Population" <https://www.worldometers.info/world-population/mauritius-population/> (accessed 2020-03-28).
[249] Bowman LW "Mauritius" <https://www.britannica.com/place/Mauritius> (accessed 2020-03-28).
[250] Republic of Mauritius "Language" <http://www.govmu.org/English/ExploreMauritius/Geography-People/Pages/Language.aspx> (accessed 2020-03-28).
[251] Angelo AH "Mauritius: The basis of the legal system" (1970) 3 *TC&ILJoSA* 230.
[252] Domingue (2002) *UMRJ*.
[253] The Commonwealth "Mauritius: Constitution and politics" <https://thecommonwealth.org/our-member-countries/mauritius/constitution-politics> (accessed 2020-03-28).
[254] Bowman LW "Mauritius" <https://www.britannica.com/place/Mauritius> (accessed 2020-03-28).
[255] The Commonwealth "Mauritius: Constitution and politics" <https://thecommonwealth.org/our-member-countries/mauritius/constitution-politics> (accessed 2020-03-28).
[256] Bowman LW "Mauritius" <https://www.britannica.com/place/Mauritius> (accessed 2020-03-28).
[257] Seechurn et al *A tale of five sectors in Mauritius: Agriculture, Textile/EPZ, Tourism, Financial Services and ICT/BPO… an employment perspective*.
[258] Information & Communication Technologies "The ICT sector in Mauritius – an overview" <https://www.icta.mu/documents/publications/ictview.pdf> (accessed 2020-03-29).

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Over the years, the government prioritised infrastructure development, especially telecommunication networks.[259] This has also enabled the transition to a services-based economy,[260] with the latter contributing more than 70% of GDP.[261]

Mauritius boasts an economic freedom score of 74,9, which makes it the twenty-first most free country in the world.[262] For comparison, it ranks between the likes of well-developed countries such as Sweden and Finland. Unsurprisingly, it has the highest rank of all African countries.[263]

As a direct result of the reforms and diversification process, Mauritius has consistently achieved GDP growth rates of over 3%.[264] This trajectory is said to continue and possibly increase in future.[265] This has led to a stable increase in wealth, and it is now regarded as the richest country in Africa.[266] Mauritius has been praised as the African success story,[267] one of the few countries that have succeeded in implementing meaningful economic reforms and diversified away from dependence on agriculture.[268] This performance is attributed to the solid fundamentals of the island country.[269] Mauritius ascended to the World Bank's GEDB ranking through this

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[259] Information & Communication Technologies "The ICT sector in Mauritius – an overview" <https://www.icta.mu/documents/publications/ictview.pdf> (accessed 2020-03-29).

[260] Bowman LW "Mauritius" <https://www.britannica.com/place/Mauritius> (accessed 2020-03-28).

[261] Monarch & Co "Benefits of investing" <http://monarchandco.com/mauritius/business/benefits-of-investing/> (accessed 2020-03-29).

[262] 2020 Index of Economic Freedom "Mauritius" <https://www.heritage.org/index/country/mauritius> (accessed 2020-03-29).

[263] 2020 Index of Economic Freedom "Mauritius" <https://www.heritage.org/index/country/mauritius> (accessed 2020-03-29).

[264] CNN Africa View "Inside Mauritius: The tropical paradise with a booming economy" <https://edition.cnn.com/2015/01/22/africa/mauritius-tropical-paradise-booming-economy/index.html> (accessed 2020-03-29).

[265] African Development Bank Group "Mauritius Economic Outlook" <https://www.afdb.org/en/countries/southern-africa/mauritius/mauritius-economic-outlook> (accessed 2020-03-29).

[266] The World Bank "GDP per capita – Mauritius" <https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?locations=MU> (accessed 2020-03-29). Afrasia "The 2019 Africa Wealth Report ranks the wealthiest countries in Africa" <https://www.afrasiabank.com/en/about/newsroom/news/2019/the-2019-africa-wealth-report-ranks-the-wealthiest-countries-in-africa> (accessed 2020-03-29).

[267] Silve A "Botswana and Mauritius: Two African Success Stories" (2012) 242 *AC* 29.

[268] Belsie L "Mauritius: African success story" <https://www.nber.org/digest/may11/w16569.html> (accessed 2020-03-29).

[269] Afrasia "The 2019 Africa Wealth Report ranks the wealthiest countries in Africa" <https://www.afrasiabank.com/en/about/newsroom/news/2019/the-2019-africa-wealth-report-ranks-the-wealthiest-countries-in-africa> (accessed 2020-03-29). Silve A "Botswana and Mauritius: Two African Success Stories" (2012) 242 *AC* 29.

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process, even overtaking South Africa and other larger economies, [270] andhas achieved the highest ranking in Africa on the WEF's GCI.[271]

One crucial component for success is good governance.[272] Mauritius has repeatedly ranked first on the Ibrahim Index of African Governance ("IIAG"), scoring 79,5.[273] It is also among the top African countries on transparency international's corruption perception index ("TICPI").[274] This is also the case for the World governance index ("WGI").[275]

In light of the above, it is understandable why Mauritius was successful in becoming a tax haven. It complies with all of a tax haven's associated features and characteristics, as discussed in paragraph 3 4 above.

3 6 Quasi-tax havens

Even though the typical characteristics and related factors associated with successfully becoming a tax haven are well defined and documented,[276] it does not mean that there are no exceptions or deviations to the rule. In some instances, one may encounter the anomaly where a jurisdiction does not possess the common tax haven attributes, nor does it fulfil the tax haven criteria or requirements. However, if the specific section is considered in isolation for all practical purposes, that portion of the regime functions as and complies with the definition of a tax haven. This does not mean that such a country obtains full tax haven status, but in a limited sense, it has

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[270] World Bank Group "Doing Business 2020: Comparing business regulation in 190 economies" (2020) *WorldBank*.

[271] Schwab "The Global Competitiveness Report 2019" (2019) *World Economic Forum*.

[272] D Dharampala & JR Hines Jr "Which countries become tax havens?" (2009) 93 *JoPE* 1058.

[273] African Governance Report Agendas 2063 & 2030 is Africa on track?" <https://mo.ibrahim.foundation/sites/default/files/2020-02/African_Governance_Report_2019.pdf> (accessed 30-03-2022).

[274] Trading Economics "Mauritius Corruption Index"<https://tradingeconomics.com/mauritius/corruption-index> (accessed 30-03-2022).

[275] François R "Why should world governance be evaluated and for what purpose?" <https://www2.world-governance.org/IMG/pdf_WGI_full_version_EN.pdf> (accessed 2020-03-28). The World Bank "Country Data report for Mauritius, 1996-2014" <http://documents.worldbank.org/curated/en/590471467996714576/pdf/105518-WP-PUBLIC-Mauritius.pdf> (accessed 2020-03-28).

[276] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1062. Kaufmann D Kraay A & Mastruzzi M "Governance matters IV: Governance indicators for 1996-2004" (2005) *World Bank Working Paper.*

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tax haven-like features, which brings it within the ambit of the definition. It is submitted that this category or subdivision of tax havens can be described as "*quasi-tax havens*".

In other words, a quasi-tax haven is something between a tax haven as it is known, which was discussed in paragraph 3 2 above and a non-tax haven. Due to the nature of quasi-tax havens, these countries will appear to be ordinary non-tax havens and only when examined in more detail does the true form become evident. The determination of such classification depends on the perspective that is applied when evaluating a country. If a holistic perspective is used, such jurisdictions fail to satisfy the tax haven definition, but if a fragmented approach is adopted, it fulfils the criteria and meets the requirements in respect of a certain fragment. For example, under this definition, jurisdictions such as the USA's Foreign Account Tax Compliance Act ("FATCA") and Belgium's excess profit regime will qualify as tax havens.[277]

If the above-mentioned classification is accepted, it may create the opportunity for other jurisdictions to enter or expand their financial services sector, which was previously excluded or discouraged from transitioning towards a tax haven. There may be numerous reasons for this, but the most noteworthy are that such jurisdictions either do not contain the desired characteristics or are unwilling to risk the potential reputational damage associated with tax haven status. The development of the quasi-tax haven concept may open the possibility for these countries to develop innovative subsections or regimes to attract FDI. This means there is no longer a limitation on a jurisdiction's choice of developmental strategy based on its external or physical attributes. The effect may be that jurisdictions can unlock new avenues of revenue that may positively contribute to global competitiveness.

3 6 1 The USA as a quasi-tax haven

This section uses the USA's FATCA regime as an example of a quasi-tax haven. The discussion begins by providing a brief overview of the key events that led to the development of the exchange of information models and, subsequently, to FATCA and the OECD's common reporting standard ("CRS"). The objective is not to provide a comprehensive discussion on the provisions of FATCA, nor those of the CRS, but

[277] The Hiring Incentives to Restore Employment Act of 2010. Section 185(2) of the Belgian Income Tax Code 1992.

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rather to provide the context required for the following discussion.[278] This discussion highlights the main differences between the FATCA and CRS frameworks, but the evaluation is limited to aspects relevant to the quasi-tax haven classification. Reference is further made to consequences where applicable. Because the USA is not one of the main comparative jurisdictions of this dissertation, it is necessary to provide background and context for the proceeding discussion.

3 6 1 1 Exchange of information

Tax treaties are the foundation of the international exchange of tax information and typically regulate the mutual assistance among the signatories in tax collection.[279] Although the primary and traditional role has largely been to eliminate or reduce tax barriers to cross-border trade and investment, their application was not limited to the aforementioned.[280] This primary objective usually entailed the prevention or reduction of double taxation.[281] However, recently the focus shifted towards what was always considered a secondary function, namely to prevent tax evasion and avoidance through the exchange of information between tax authorities.[282]

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[278] Aside from illustrating the quasi-tax haven concept, a discussion of the application of FATCA and the CRS to South Africa and other treaties and DTAs falls outside the ambit of the dissertation.
[279]Arnold B "An introduction to tax treaties" <https://www.un.org/esa/ffd/////wp-content/uploads/2015/10/TT_Introduction_Eng.pdf> (accessed 2021-03-28).
Pickering A "Why negotiate tax treaties?" <https://www.un.org/esa/ffd/wp-content/uploads/2013/05/20130530_Paper1N_Pickering.pdf> (accessed 2021-03-28).
O'Conner W, "The role of tax treaties in international taxation" (2002) *The International Taxation System* 124.
[280] Parikh B, Jain P and Spahr RW "The impact of double taxation treaties on cross-border equity flows, valuations and cost of capital" <https://www.researchgate.net/publication/228433877_The_Impact_of_Double_Taxation_Treaties_on_Cross_Border_Equity_Flows_Valuations_and_Cost_of_Capital> (accessed 2021-03-28).
O'Conner W "The role of tax treaties in international taxation" (2002) *The International Taxation System* 126.
Davies RB "Tax treaties and foreign direct investment: potential versus performance" (2004) *International Tax and Public Finance* 777.
Barthel F, Busse M and Neumeyer E "The impact of double taxation treaties on foreign direct investment: evidence from large dyadic panel data" <https://www.researchgate.net/publication/45514889_The_Impact_of_Double_Taxation_Treaties_on_Foreign_Direct_Investment_Evidence_From_Large_Dyadic_Panel_Data> (accessed 2021-03-28).
Davies RB "Tax treaties, renegotiations, and foreign direct investments" (2003) *Economic Analysis and Policy* 253-254.
[281] Postlewaite PF and Makarski DS "The A.L.I. tax treaty study – a critique and a modest proposal" (1999) *The Tax Lawyer* 734.
[282] Driessen P "Is there a tax insularity complex?" (2012) *Tax Notes* 245.

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The first exchange of information agreements originated in 1843 between Belgium and France and in 1845 between Belgium and the Netherlands.[283] In the 1920s, The League of Nations' Committee of Technical Experts on Double Taxation and Tax Evasion published the first model tax conventions, which made provision for the bilateral exchange of information.[284] This model served as the foundation for the model that the OECD subsequently adopted in 1963.[285] The provision regarding the exchange of information upon request ("EIUR") quickly became the leading framework for the international exchange of information in tax matters.[286]

The "upon request" process traditionally operates in the following way: the requesting country initialises the request for the specific information sought by submitting the taxpayer or taxpayers' details.[287] This is followed by the reviewing country first determining whether the treaty partner requesting the information had a legitimate reason to seek the information. The request is only granted and the information provided if the cause is established and the information is successfully obtained from domestic financial institutions.[288] Eventually, in 1979 the Council of Europe and the OECD issued a Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which took effect in 1995.[289]

The true tipping point was only reached with the release of the OECD's Report on Harmful Tax Competition, which emphasised the risks posed by harmful tax practices and the paramount importance of transparency provisions.[290] This ultimately laid the foundation for the development of the OECD's fifteen-point action plan.

According to the OECD, the ability or willingness of a country to provide information to other countries is a key factor in determining whether the justification for such a regime is purely tax driven and whether the regime has the potential to

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[283] Jogarajan S "Prelude to the international tax treaty network: 1815-1914 early tax treaties and the conditions for action" (2011) 31 *Oxford Journal of Legal Studies* 671.
[284] The Committee of Technical Experts on Double Taxation and Tax Evasion, League of Nations 1927.
[285] Organisation for Economic Co-operation and Development "Draft Double Taxation Convention on Income and Capital 1963" <https://doi.org/10.1787/9789264073241-en> (accessed 2021-03-29).
[286] Oberson X *International Exchange of Information in Tax Matters* 2 ed (2018) 5.
[287] Vasco DC and Porporatto P "Progress in transparency and exchange of tax information" (2013) *Tax Administration Review No 35*. 76.
[288] Spencer D "Exchange of tax information" *Accountancy business and the Public Interest* 5(1) 91.
[289] Organisation for Economic Co-operation and Development *Journal council of Europe /OECD convention on mutual administrative assistance in tax matters* (1988).
[290] Organisation for Economic Co-operation and Development *Harmful Tax Competition* (1998).

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cause harmful spillover effects.[291] If a jurisdiction is uncooperative, it is an early indication that such a regime has the potential to be abused. This further underlines the need for adequate mechanisms for the exchange of information.

One big obstacle to the effective exchange of information is a country's bank secrecy rules. These provisions have a wide range of legitimate applications but are also open to misuse.[292] Undeniably, these provisions are valued by clients but a challenge for transparency.[293] The introduction of a minimum standard for EIUR was a noteworthy milestone, which was quickly expanded with the publication of the framework for tax information exchange agreements ("TIEA").[294] The model TIEA subsequently resulted in limiting the bank secrecy rules defence. Thus, the requested state could no longer decline to provide information based solely on bank secrecy rules.[295]

The drive towards global transparency was significantly accelerated in the ensuing years, with the advent of the financial crisis in 2008 and the disclosure of the numerous global banking scandals.[296] These developments, coupled with increased media exposure led to the unprecedented negotiation of hundreds of full double taxation conventions based on the OECD Model, as well as various TIEAs with offshore banking jurisdictions.[297] This overwhelming support for the transparency movement was emphasised by the statement made by the leaders at the London G20 summit, which unequivocally stated that "the era of bank secrecy is over".[298]

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[291] Organisation for Economic Co-operation and Development *Harmful Tax Competition: An Emerging Global Issue* (1998).

[292] Schottenstein JH "Is bank secrecy still bankable? A critical review of bank secrecy law, tax evasion and UBS" (2009) 5 *Entrepreneurial Business Law Journal* 352.

[293] Knobel A and Meinzer M "The end of bank secrecy? Bridging the gap to effective automatic information exchange" (2014) *SSRN Electronic Journal*.

[294] Committee on Fiscal Affairs, "Improving Access to Bank Information for Tax Purposes" (April 2000).

[295] Organisation for Economic Co-operation and Development *Terms of Reference to Monitor and Review Progress Towards Transparency and Exchange of Information for Tax Purposes* (2010).

[296] Financial Stability Board "Global shadow banking monitoring report 2017".
Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.

[297] Willis A "Switzerland, Austria and Luxembourg relax banking secrecy" <https://euobserver.com/economic/27775> (accessed 2021-04-05).
Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).
Gadžo S and Klemenčić I "Effective international information exchange as a key element of modern tax systems: promises and pitfalls of the OECD's common reporting standard" (2017) *Public Sector Economics* 41 209.

[298] G20, "The Global Plan for Recovery and Reform, Final Communique of the G20 Summit Held in London on 2 April 2009".

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Despite their American tax obligations, many Americans had secret offshore accounts.[299] These accounts were never disclosed to the tax authority, which resulted in potentially billions of dollars in unreported income each year.[300] Even though American financial institutions ("AFI") are obliged to report income earned by American taxpayers, foreign financial institutions do not have a similar obligation.[301] This enabled American residents to circumvent American taxes by using foreign accounts and foreign entities.[302]

After the revelation that many qualified intermediaries were not reporting the income received on accounts held by American taxpayers to the Treasury, the USA elected to develop their own exchange of information model.[303] This resulted in the subsequent adoption of the FATCA legislation and framework in 2010.[304] The objective of FATCA was to curb tax evasion among American residents by placing an obligation on foreign institutions to report accounts owned by American residents and to withhold the 30% tax.[305]

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[299] Johannesen N, Langetieg P, Reck D, Risch M and Slemrod J "Taxing hidden wealth: The consequences of U.S. enforcement initiatives on evasive foreign accounts" <http://www.law.nyu.edu/sites/default/files/upload_documents/Slemrod%20Week%2013.pdf> (accessed 2021-04-05).

[300] United States Senate Permanent Subcommittee on Investigations "Offshore tax evasion: The effort to collect unpaid taxes on billions in hidden offshore accounts" <https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20OFFSHORE%20TAX%20EVASION%20(Feb%2026%202014,%208-20-14%20FINAL).pdf> (accessed 2021-04-05).

[301] Byrnes WH and Munro RJ *Lexis Nexis Guide to FATCA and CRS Compliance 2018 Edition* (2018).

[302] Cotorceanu PA "Hiding in plain sight: how non-US persons can legally avoid reporting under both FATCA and GATCA" (2015) 21 *Trustees and Trusts* 1052.

[303] United States Senate Permanent Subcommittee on Investigations "Offshore tax evasion: The effort to collect unpaid taxes on billions in hidden offshore accounts" <https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20OFFSHORE%20TAX%20EVASION%20(Feb%2026%202014,%208-20-14%20FINAL).pdf (accessed 2021-04-05).
Morse SC "Qualified intermediary or bust?" (2009) *Tax Notes* 124.
Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters: from double tax treaties to FATCA and CRS" (2016) *Trustees & Trusts* 22(8) 890.
Harvey Jr. RJ "Offshore accounts: insider's summary of FATCA and its potential future" (2012) *Villanova Law Review* 473.

[304] The Hiring Incentives to Restore Employment Act of 2010.

[305] Deloitte "The road ahead: an in-depth analysis of the temporary and final FATCA regulations incorporating notice 2014-33" <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-fatca-incorporating-notice-091714.pdf> (accessed 2021-04-06).
Byrnes WH and Munro RJ *Lexis Nexis Guide to FATCA and CRS Compliance 2018 Edition* (2018).

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The next milestone was reached in 2013, with the endorsement of automatic exchange as the new standard by the G20 Finance Ministers.[306] The introduction of the automatic exchange framework addressed many of the inadequacies of the EIUR model.[307] The EU was at the forefront of adopting automatic exchange provisions for member states [308] and has played a pivotal role in developing the OECD's automatic exchange of tax information framework.

Shortly thereafter, the G20 Finance Ministers also ratified the CRS in 2014.[309] Unfortunately, not all jurisdictions opted to support the CRS project. The USA opposed the OECD's CRS initiative, simply because it offered no benefit.[310] Seeing that FATCA was already in full force, the USA already had their own information exchange network.[311] This was achieved by concluding numerous inter-governmental agreements ("IGA") with other countries, which gave effect to the provisions of FATCA.[312] As a result of the widespread adoption of the IGAs, the OECD decided to base the CRS model on FATCA.[313]

The CRS framework is a standardised model regulating information exchange between member countries.[314] It requires jurisdictions to obtain information from their financial institutions and automatically exchange that information with other

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[306] Organisation for Economic Co-operation and Development "OECD Secretary-general report to the G20 Finance ministers and central bank governors <https://star.worldbank.org/sites/star/files/oecd_tax_report_to_g20_finance_ministersinternorg.pdf> (accessed 2021-04-06).

[307] Financial Transparency Coalition "Automatic exchange of tax information. A primer on concepts, loopholes and developing countries' concerns" <https://financialtransparency.org/wp-content/uploads/2018/05/Automatic-Exchange-of-Tax-Information.pdf> (accessed 2021-04-07).
Organisation for Economic Co-operation and Development *Standard for automatic exchange of financial account information in tax matters* (2014).

[308] Directive 88/361/EEC, 8 July 1988. Council Directive 2003/48/EC, 26 June 2003.

[309] E Rahimi-Laridjani & E Hauser "The new global FATCA: an overview of the OECD's common reporting standard in relation to FATCA" (2016) 13 *Journal of Taxation of Financial Products* 9.

[310] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T&*T* 892.

[311] Hiran BS, *"Overview of FATCA"* (2016) *Tax Notes* 152.

[312] Avi-Yonah RS & Savir G "Find it and tax it: from TIEAs to IGAs" (2015) *Law & Legal Theory Research Paper Series No 443.*

[313] Blank JD & Mason R "Exporting FATCA" (2014) *Tax Notes* 142.
Grinberg I "The battle over tax offshore accounts" (2012) 60 *UCLA Law Review* 335.

[314] Organisation for Economic Co-operation and Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).

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jurisdictions annually.[315] It sets out the financial account information to be exchanged, the financial institutions that are required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.[316]

3 6 1 2 FATCA and the CRS

Although the CRS was modelled on FATCA, there are noteworthy differences.[317] Many of these deviations stem from the fact that the CRS is a multinational agreement, in contrast to FATCA, which is largely unilateral in nature and specifically tailored to the USA.[318] Most of these variations are technical and pertain to the definitions and terminology used.[319] To a large degree, these subtle differences do not have a major effect on the operations or functioning of either framework. However, others are more substantial, with wide-reaching consequences.[320] These are briefly mentioned, whereafter the discussion focuses on the more serious differences.

These differences can be classified into the following broad categories: inclusion thresholds, sponsorship options, jurisdictional determination, entity classification,

[315] Deloitte "Understanding and implementing the common reporting standard requirements" <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-dbriefs-understanding-and-implementing-crs-requirements-011216.pdf> (accessed 2021-04-17).

[316] Organisation for Economic Co-operation and Development *Standard for automatic exchange of financial information in tax matters* (2014); Organisation for Economic Co-operation and Development *Convention on mutual administrative assistance in tax matters* (2020); Organisation for Economic Co-operation and Development *Automatic exchange of information: what it is, how it works, benefits, what remains to be done* (2012); Organisation for Economic Co-operation and Development *Keeping it safe: The OECD guide on the protection of confidentiality of information exchanged for tax purposes* (2012). Organisation for Economic Co-operation and Development Report for the G8 Summit 2013 "A step in change in tax transparency; Organisation for Economic Co-operation and Development *Model mandatory disclosure rules for CRS avoidance arrangements and opaque offshore structures* (2019) Organisation for Economic Co-operation and Development *International exchange framework for mandatory disclosure rules on CRS avoidance arrangements and opaque offshore structures* (2019).

[317] KPMG "The common reporting standard: are you ready?" <https://assets.kpmg/content/dam/kpmg/pdf/2016/03/the-common-reporting-standard.pdf> (accessed 2021-04-19).

[318] Noked N "FATCA, CRS and the wrong choice of who to regulate" (2018) *Florida Tas Review* 22(1) 99-100.

[319] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T&*T* 892-893.

[320] Rahimi-Laridjani & Hauser (2016) *Journal of Taxation of Financial Products* 9.

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reportable assets, types of accounts, and diligence requirements.[321] In many of these examples, the CRS has tried to simplify or clarify some of the definitions or to make them more applicable to the wider reach by adding certain sections, inserting additional provisions, or removing sections that may lead to unnecessary complexity.[322]

Depending on the perspective, one may regard the above-mentioned deviations as either an improvement to the FATCA model or as negative changes, but regardless of the view, it has little to no material impact on the functioning of the framework. However, there are also specific differences in how the CRS operates compared to FATCA.[323] These minor but crucial discrepancies open the potential for ulterior motives.

As one can infer from the discussion in paragraph 3 5 1 1 above, the OECD has worked towards achieving the global transparency objective for decades.[324] This goal was finally within grasp with the development and launch of the CRS.[325] It is, therefore, not surprising that the core pillars of the CRS are collective agreement, mutual assistance and reciprocity.[326] This is evident from the way in which the model is designed to work. FATCA adopts more of a strongarm approach.[327]

The USA has opted to make participation in the FATCA regime compulsory.[328] FATCA imposes a withholding penalty on institutions that do not comply with its requirements.[329] This penalty is a powerful incentive to encourage countries to sign

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[321] KPMG "The common reporting standard: are you ready?" <https://assets.kpmg/content/dam/kpmg/pdf/2016/03/the-common-reporting-standard.pdf> (accessed 2021-04-19).

[322] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T&*T* 892-893.

[323] Byrnes WH and Munro RJ *Lexis Nexis Guide to FATCA and CRS Compliance 2018 Edition* (2018).

[324] Gadžo S and Klemenčić I "Effective international information exchange as a key element of modern tax systems: promises and pitfalls of the OECD's common reporting standard" (2017) 41 *Public Sector Economics* 209.

[325] Organisation for Economic Co-operation and Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).

[326] Organisation for Economic Co-operation and Development *Standard for Automatic exchange of financial account information in tax matters 9-10* 2 ed (2017).

[327] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T&*T* 892-893.

[328] Rahimi-Laridjani & Hauser (2016) *Journal of Taxation of Financial Products* 9.

[329] Deloitte "The road ahead: an in-depth analysis of the temporary and final FATCA regulations incorporating notice 2014-33" <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-fatca-incorporating-notice-091714.pdf> (accessed 2021-04-06).

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IGAs and entities to exchange information. In contrast, the CRS does not contain such a penalty—countries that do not exchange information will not have information shared with them.[330] Aside from the aforementioned and possible diplomatic backlash, non-participation has no consequences.[331] The downside of the CRS's approach is that only countries with a material interest in receiving information will be motivated to support the project.[332] It is unclear whether this will be a sufficient incentive for low-tax jurisdictions.

Even though the USA has committed to also exchange information under the IGAs, it is limited to interest earned on bank deposits and limited categories of American source income earned on other accounts.[333] This means the USA is receiving unhindered information on American residents from all these jurisdictions, but the country does not always reciprocate the gesture.[334] Should they do so, the information provided is very limited.[335] This may explain why the USA is not interested in adopting the CRS.

The USA's position is unlikely to change anytime soon.[336] First, most of the data that the CRS requires to be exchanged is not currently reported to the tax authorities by AFIs. [337] Naturally, the USA cannot promise to give data it does not collect.

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[330] KPMG "The common reporting standard: are you ready?" <https://assets.kpmg/content/dam/kpmg/pdf/2016/03/the-common-reporting-standard.pdf> (accessed 2021-04-19).
Deloitte "The road ahead: an in-depth analysis of the temporary and final FATCA regulations incorporating notice 2014-33" <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-fatca-incorporating-notice-091714.pdf> (accessed 2021-04-06).
[331] Rahimi-Laridjani & Hauser (2016) *Journal of Taxation of Financial Products* 9.
[332] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T&*T* 896.
[333] L Parada "Intergovernmental agreements and the implementation of FATVA in Europe" (2015) 7 *World Tax Journal* 201.
[334] I Grinberg "The battle over taxing offshore accounts" (2012) 60 *UCLA Law Review* 336.
[335] B Zagaris "The International Financial Regulation and Enforcement Regime: Implications for Financial Intermediaries" <http://www.nysba.org/WorkArea/DownloadAsset.aspx?id=71287> (accessed 2021-04-19).
[336] United States Government Accountability Office *GAO-19-180, Foreign Asset Reporting: Actions needed to enhance compliance efforts, eliminate overlapping requirements and mitigate burdens on US persons abroad 3-4 (2019).*
United States Government Accountability Office *GAO-13-318, Offshore tax evasion: IRS has collected billions of dollars, but may be missing continued evasion* (2013).
United States Government Accountability Office *GAO-12-484, Foreign account reporting requirements: IRS needs to further develop risk, compliance and cost plans* (2012).
[337] Cotorceanu PA "Hiding in plain sight: how non-US persons can legally avoid reporting under both FATCA and GATCA" (2015) *Trustees and Trusts* 21(10) 1052.

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Therefore, unless and until American law is changed to mandate CRS-style reporting, the USA simply cannot agree to such an exchange.[338] Second, there is little likelihood that the laws will be amended soon to allow the collection of the aforementioned data. Also, there is no need. The USA already gets all the information it requires on American taxpayers through FATCA, so it does not need the CRS to find its own tax evaders.[339] Moreover, the USA's banking regulation is split between federal and state authorities, which means that CRS would be very difficult to pass.[340] States such as Delaware, Nevada, Florida and Wyoming, all with very strict banking confidentiality regulations, would definitely oppose the passing of a federal law on CRS in Congress. Lastly, expanding the USA's data exchange would only damage the thriving banking industry and destroy the USA's competitive advantage.[341]

This punitive and unilateral nature of FATCA places the USA in a dominant position. Not only can it dictate the information it desires, but it can also force any jurisdiction to comply and decide what information to provide to other countries if anything at all.[342]

Under the CRS, none of the aforementioned would be possible. All partner jurisdictions are on an equal footing and would be able to protest this lack of full exchange by refusing to transmit information to the USA.[343] Unfortunately, under FATCA's withholding penalty, there is little that the countries can do.[344]

3 6 1 3 Evaluating the USA

Based on the preceding discussion, it is evident that the USA has managed to place itself in a unique and envious position. However, it begs the question, is this just an

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[338] Christians A "What you give and what you get: reciprocity under a model 1 intergovernmental agreement on FATCA" (2013) *Cayman Financial Review* 24.

[339] S-Y Oei "The offshore tax enforcement dragnet" (2018) 67 *Emory Law Journal* 682-684.

[340] Cotorceanu PA "Hiding in plain sight: how non-US persons can legally avoid reporting under both FATCA and GATCA" (2015) 21 *Trustees and Trusts* 1052-1054.

[341] H Christensen & J-M Tirard "The amazing development of exchange of information in tax matters" T&*T* 898.

[342] Kim YR "Considering 'Citizenship taxation': in defense of FATCA" (2017) *Florida Law Review* 335 360. Oei S-Y (2018) *Emory Law Journal* 682-684. Avi-Yonah & G Savir "Find it and tax it: from TIEAs to IGAs" (2015) *Michigan Law Public Law & Legal Theory Research Paper Series Paper no. 443.*

[343] Byrnes WH and Munro RJ *Lexis Nexis Guide to FATCA and CRS Compliance 2018 Edition* (2018). Organisation for Economic Co-operation and Development *Standard for automatic exchange of financial account information in tax matters 9-10 (2nd edition* 2017).

[344] Blank JD & Mason R "Exporting FATCA" (2014) *Tax Notes* 142.

Grinberg I "The battle over tax offshore accounts" (2012) 60 *UCLA Law Review* 335.

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unintended side effect of an amalgamation of events, or is it a well-orchestrated plan to overthrow tax haven jurisdictions just to take their business?[345] Before one can answer this question, it is paramount to first establish whether the USA can be classified as a tax haven.

At face value, it is immediately apparent that the USA does not possess the typical tax haven characteristics nor conform to the perception of a tax haven.[346] First, the USA has one of the largest populations and geographic areas in the world.[347] Ironically, the aforementioned factors constitute two of the main features associated with tax haven status and have statistical significance. However, the USA fulfils the good governance requirement,[348] which also has a strong correlation. In addition, it contains many of the supporting or related attributes, with the exception of limited natural resources.[349] Therefore, the USA is an anomaly. It does not mean that it is

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[345] Cotorceanu P "Why America loves being the world's no.1 tax haven" <https://www.politico.eu/article/why-america-loves-being-the-worlds-no-1-tax-haven-panama-papers-data/> (accessed 2021-04-21).
Knobel A "The Role of the U.S. as a Tax Haven: Implications for Europe" <https://www.greens-efa.eu/en/article/news/the-role-of-the-united-states-as-a-tax-haven> (accessed 2021-04-21).
Tax Justice Network "Financial Secrecy Index 2018: Narrative Report on USA" <http://www.financialsecrecyindex.com/PDF/USA.pdf> (accessed 2021-04-21).
Noked N "Tax Evasion and Incomplete Tax Transparency" (2018) *International Tax Law and Policy.*

[346] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1062.

[347] Worldometer "World population – US population" <https://www.worldometers.info/world-population/us-population/> (accessed 2021-04-24).
The World Bank "Land area (sq-km) – United States" <https://data.worldbank.org/indicator/AG.LND.TOTL.K2?locations=US> (accessed 2021-04-24).

[348] World Wide Governance Indicators <https://info.worldbank.org/governance/wgi/Home/Reports> (accessed 2021-04-24).
Transparency International <https://www.transparency.org/en/countries/united-states> (accessed 2021-04-24).

[349] 2021 Index of Economic Freedom <https://www.heritage.org/index/country/unitedstates#:~:text=The%20United%20States'%20economic%20freedom,freest%20in%20the%202021%20Index> (accessed 2021-04-22).
Vile MJC "Politics in the USA" <http://www.untag-smd.ac.id/files/Perpustakaan_Digital_2/POLITICS%20AND%20GOVERNMENT%20Politics%20in%20the%20USA.pdf> (accessed 2021-04-22).
One World Nations Online "Official spoken languages of the countries of the Americas and the Caribbean" <https://www.nationsonline.org/oneworld/american_languages.htm> (accessed 2021-04-22).
Lucky RW and. Eisenberg J "Renewing U.S. Telecommunications Research" <https://web.ece.ucsb.edu/Faculty/Rabiner/ece259/Reprints/360_US%20Telecom%20Research.pdf> (accessed 2021-04-22).
Friedman LM & Hayden GM *American law: an introduction* (1930) 3rd edition.
National Geographic "North America: Resources" <https://www.nationalgeographic.org/encyclopedia/north-america-resources/> (accessed 2021-04-22).

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impossible for the USA to successfully become a tax haven, but rather that it is an outlier, and the likelihood is diminished.

Aside from the physical qualities, it is essential to analyse the USA's offering and how it compares to the tax haven criteria.[350] The point of departure is always the tax rate. This alone is not decisive but provides a good indication.

The USA has a moderate corporate tax rate of 21%.[351] This is significantly down from 35% prior to the 2017 amendments.[352] It uses a progressive tax rate, which ranges between 10% and 37% for individuals.[353] The USA further applies a residency-based system, which means that American residents are taxed on their worldwide income.[354] Non-residents are only taxed on American source income.[355] These rates are well within the global average and lean towards the upper end of the scale. Hence, the first requirement is not met, but it is not the end of the enquiry.

The second requirement pertains to the accessibility of the regime. If it is exclusively reserved for non-residents, it may be an indication that it is a tax haven. In other words, if the regime is ring-fenced from the domestic economy. The USA does not offer a special or different tax rate for non-residence.[356] Thus, the second requirement is not fulfilled either.

The United States and Canada "Economic Geography" <https://www.fortbendisd.com/cms/lib09/TX01917858/Centricity/Domain/1006/us_ecn_geo.pdf> accessed 2021-04-22).

[350] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998). Council of the European Union "Code of Conduct Group (Business Taxation)" ECOFIN Council on 29 November 1999; OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018); Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*.

[351] Trading Economics "United States Federal Corporate Tax Rate" <https://tradingeconomics.com/united-states/corporate-tax-rate> (accessed 2021-04-23).

[352] *Tax Cuts and Jobs Act* of *2017*

[353] PricewaterhouseCoopers "United States: individual- taxes on personal income" <https://taxsummaries.pwc.com/united-states/individual/taxes-on-personal-income> (accessed 2021-04-23).

[354] PricewaterhouseCoopers "United States: individual- taxes on personal income" <https://taxsummaries.pwc.com/united-states/individual/taxes-on-personal-income> (accessed 2021-04-23).

[355] Deloitte "Taxation of foreign nationals by the US-2016" <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-taxation-of-foreign-nationals-by-the-us.pdf> (accessed 2020-02-24).

[356] Deloitte "Taxation of foreign nationals by the US-2016" <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-taxation-of-foreign-nationals-by-the-us.pdf> (accessed 2020-02-24).

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The next section of the enquiry focuses on transparency and the exchange of information. If a jurisdiction is hesitant or uncooperative to participate in collecting and exchanging information, it is a clear sign that such jurisdiction is trying to hide information, typically if the appeal hedges on secrecy.[357]

After the inception of the OECD's harmful tax competition initiative,[358] the USA also started their drive to clamp down on secrecy jurisdictions and tax havens. Following the bank scandals and financial crises,[359] it ultimately resulted in the pioneering of FATCA.[360] Over and above the extensive network of IGAs, the USA has signed numerous DTAs, treaties and TIEAs.[361] With such a collection of partner jurisdictions and this wide range of agreements, the USA has certainly ticked all the boxes. Therefore, neither the third nor the fourth requirement is satisfied.

However, the efficacy of these agreements can be questioned, especially considering that most of them are IGAs, which affect the provisions of FATCA.[362] This means that the USA will, in most cases, only share very limited information.[363] Unfortunately, the threshold has been set very low.

The last requirement revolves around substantial economic activity. If the benefits are available without any meaningful economic activity, it is usually an indication that the regime is purely tax driven. In the case of the USA, there is no differentiation in the applicable tax rates based on the capital's purpose or the sector in which the entity operates. Thus, the fifth requirement is also not fulfilled.

In summary, as the above analyses have shown if the USA is viewed holistically, it does not comply with the tax haven criteria. For this reason, the USA cannot be classified as a tax haven jurisdiction. However, this does not mean this is the end of

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[357] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).
[358] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).
[359] Financial Stability Board "Global shadow banking monitoring report 2017".
Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.
[360] Hiran BS "Overview of FATCA" (2016) *Tax Notes* 152 1298.
[361] Oei S-Y "The offshore tax enforcement dragnet" (2018) *Emory Law Journal* 67(655) 682-684.
Avi-Yonah and Savir G "Find it and tax it: from TIEAs to IGAs" (2015) *Michigan Law Public Law & Legal Theory Research Paper Series Paper no. 443.*
[362] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T&*T* 898.
[363] Christians A "What you give and what you get: reciprocity under a model 1 intergovernmental agreement on FATCA" (2013) *Cayman Financial Review* 24.

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the road. There are still many ambiguous aspects, particularly surrounding the FATCA framework. It, therefore, begs the question, is the USA a quasi-tax haven?

If one examines the object and provisions of FATCA, it becomes evident that it is designed and tailored for the USA.[364] It was always intended to be a one-sided framework, which stems from its formulation and unilateral nature.[365] The limited transmission of information appears to be merely an attempt at window dressing. However, FATCA has created this impenetrable veil of secrecy for non-residents by refusing to reciprocate the same level of information received.[366]

As a result of the former, foreign residents can now shift their assets and wealth to the USA without the risk that their home country will be notified of their offshore holdings.[367] This creates the perfect framework for the USA to attract large amounts of FDI, and if structured properly, can offer substantial tax savings for the investors.

The potential consequences of this development are so severe that the USA has subsequently moved up from sixth on the FSI rankings to third.[368] The severity of the side effects created by the FATCA regime becomes more apparent if coupled with and viewed in the context of the already accommodative frameworks encountered in many of the states.[369] States such as Nevada, Florida, Delaware, Montana, South Dakota, Wyoming and New York are particularly renowned for their relaxed regulations, liberal trust legislation and almost non-existing taxation.[370]

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[364] Byrnes WH and Munro RJ *Lexis Nexis Guide to FATCA and CRS Compliance 2018 Edition* (2018).
Grinberg I "The battle over taxing offshore accounts" (2012) *UCLA Law Review* 60(304) 336.
[365] Blank JD & Mason R "Exporting FATCA" (2014) *Tax Notes* 142.
[366] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T*&T* 899.
[367] Cotorceanu P "Why America loves being the world's no.1 tax haven" <https://www.politico.eu/article/why-america-loves-being-the-worlds-no-1-tax-haven-panama-papers-data/> (accessed 2021-04-21).
Knobel A "The Role of the U.S. as a Tax Haven: Implications for Europe" <https://www.greens-efa.eu/en/article/news/the-role-of-the-united-states-as-a-tax-haven> (accessed 2021-04-21).
Tax Justice Network "Financial Secrecy Index 2018: Narrative Report on USA" <http://www.financialsecrecyindex.com/PDF/USA.pdf> (accessed 2021-04-21).
Noked N "Tax Evasion and Incomplete Tax Transparency" (2018) *International Tax Law and Policy.*
[368] Tax Justice Network "Financial Secrecy Index 2018: Narrative Report on USA" <http://www.financialsecrecyindex.com/PDF/USA.pdf> (accessed 2021-04-21).
Noked N "Tax Evasion and Incomplete Tax Transparency" (2018) *International Tax Law and Policy.*
[369] Christensen H and Tirard J-M "The amazing development of exchange of information in tax matters" T*&T* 898.
[370] Rose C "The biggest tax haven of them all? The U.S. FATCA and the CRS" <https://www.bna.com/biggest-tax-haven-b57982069147> (accessed 2021-04-22)

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To illustrate the point, the author will briefly mention how a trust can be structured to reduce one's tax liability and provide asset protection. However, a detailed discussion of the technical aspects and the working of American trust law falls outside the scope of this dissertation. In addition, the choice of state will also have a material effect and is an important consideration based on the specific circumstances. The best part is that the proposed structure is available for both Americans and foreign residents.

The ideal structure to use for this objective is a trust. However, it is crucial that the trust has an American resident trustee and should be structured to comply with the foreign trust definition for USA tax purposes.[371] If such trust structure is used, it is thus possible for foreign residents to avoid the reporting obligations under both FATCA and the CRS, while also not being subjected to worldwide tax in the USA.[372] A similar structure can be used for American residents but will not offer protection against the reporting requirements.

The question may come to mind, will this all change if the USA becomes a CRS participating jurisdiction? The short answer is no. This stems from the look-through exception. Unlike other countries, the USA would not be required to disclose the controlling persons of such opaque entities.[373] It is further unknown whether the anti-

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[371] Cotorceanu PA "Hiding in plain sight: how non-US persons can legally avoid reporting under both FATCA and GATCA" (2015) *Trustees and Trusts* 21(10) 1052.

[372] Cotorceanu PA "Hiding in plain sight: how non-US persons can legally avoid reporting under both FATCA and GATCA" (2015) *Trustees and Trusts* 21(10) 1052-1053.
Rose C "The biggest tax haven of them all? The U.S. FATCA and the CRS" <https://www.bna.com/biggest-tax-haven-b57982069147> (accessed 2021-04-22).
Casi-Eberhard E, Spengel C and Stage B "Cross-border tax evasion after the common reporting standard: game over?" (2018) *Centre for European Economic Research Discussion Paper No. 18-036.*

[373] Cotorceanu PA "Hiding in plain sight: how non-US persons can legally avoid reporting under both FATCA and GATCA" (2015) *Trustees and Trusts* 21(10) 1052-1053.
The OECD confers a preferential treatment on the USA. No other country enjoys the same benefit. Under the CRS, a so-called Investment Entity Financial Institution ("IEFI") resident in a Non-Participating Jurisdiction must be treated as a Passive Non-Financial Entity ("Passive NFE") and looked through for its Controlling Persons. The rule is designed to prevent client structures such as trusts and holding companies, which will generally be IEFIs, being established in Non-Participating Jurisdictions with the aim to hide otherwise reportable persons. Since the structures themselves would be in Non-Participating Jurisdictions, they would not be doing any reporting themselves. Pursuant to this rule, however, any Financial Institution that is in a Participating Jurisdiction that holds an account for such an entity will have to treat the structure as a Passive NFE and report its Controlling Persons to any partner jurisdiction where they reside. Unless, the Financial Institution where the account is held is in the USA. In such case, if the USA does participate in the CRS, its Financial Institutions would be exempt from this look-through rule.

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avoidance provisions of the CRS will cover such a structure. This most likely depends on the interpretation used.[374] However, the anti-avoidance provisions of FATCA will not be applicable. This is due to the wording used and their limited ambit.[375]

Based on the above discussion, it is clear that the USA does, in fact, function as a tax haven. To this extent, the USA can be classified as a quasi-tax haven. By utilising a foreign trust for foreign residents, it offers both protection from the reporting obligations under FATCA and the CRS and substantial tax savings.[376] It also offers a range of tax mitigation options for American residents.

Aside from the tax and privacy benefits, the USA offers political stability, a thriving economy, a respected legal system, liberal trust laws, impenetrable asset protection laws, and advanced infrastructure.[377] Considering the above, it is not surprising that a massive wealth migration has begun.

Whether this is an unintended side effect of a noble endeavour or part of a carefully crafted strategy to overtake the offshore sector is debatable. Whichever the case might be, the USA has become one of the most sought-after tax havens.

3 6 2 Belgium as a quasi-tax haven

This section uses Belgium's excess profit regime as an example of a quasi-tax haven.[378] The discussion commences with a brief explanation of the purpose of "state aid" and how it functions in the EU context. The objective is merely to provide a basic understanding of the term and is not a comprehensive overview. The section will conclude with an evaluation and explanation of the excess profit regime and apply that

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KPMG "Who will be in scope of the AEoL?" <https://assets.kpmg/content/dam/kpmg/pdf/2016/06/ch-who-will-be-in-scope-of-the-aeoi-en.pdf> (accessed 2021-04-23).

[374] Organisation for Economic Co-operation and Development *Model mandatory disclosure rules for CRS avoidance arrangements and opaque offshore structures* (2018).
Tax Justice Network "OECD rules vs CRS avoidance strategies: not bad but short of teeth and too dependent on good faith" <https://www.taxjustice.net/2018/03/27/oecd-rules-vs-crs-avoidance-strategies-not-bad-but-short-of-teeth-and-too-dependent-on-good-faith/> (accessed 2021-04-23).
KPMG "Who will be in scope of the AEoL?" <https://assets.kpmg/content/dam/kpmg/pdf/2016/06/ch-who-will-be-in-scope-of-the-aeoi-en.pdf> (accessed 2021-04-23).

[375] Cotorceanu PA "Hiding in plain sight: how non-US persons can legally avoid reporting under both FATCA and GATCA" (2015) 21 *Trustees and Trusts* 1052-1053.

[376] C Rose "The biggest tax haven of them all? The U.S. FATCA and the CRS" (undated) *BNA* <https://www.bna.com/biggest-tax-haven-b57982069147> (accessed 2021-04-22).

[377] Rose "The biggest tax haven of them all? The U.S. FATCA and the CRS" (undated) *BNA*.

[378] In the context of trusts and wealth planning, another possible example is the general lack of capital gains tax for privately held shares.

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to the quasi-tax haven classification. The discussion on the excess profit regime is limited to those aspects relevant to the classification, and the possible consequences where applicable. In addition, the recent case law on this subject is mentioned, but an in-depth analysis falls outside the scope of this dissertation. Although Belgium is one of the main comparative jurisdictions, discussing this example in any more detail will achieve no real purpose, seeing that South Africa is not a member of such a structure as the EU, and therefore the state aid concept is foreign to South Africa. Lastly, South Africa does not have a similar system to the excess profit regime.

3 6 2 1 State aid

State aid is a European Commission ("EC") term which refers to an arrangement where a state body supports another organisation in one way or another.[379] The EU distinguishes between permissible state aid and illegal state aid.[380] State aid is only allowed in very limited circumstances if it falls within one of the exemptions or notifications and is compatible with the common market.[381]

The principle of state aid is rooted in EU competition law and forms a core pillar of the trade relations among the EU members.[382] The overarching aim is to ensure fairness and to prevent an unequal playing field from arising.[383] Moreover, the values embedded in the state aid rule correspond with the founding principles of the EU that constitutes the foundation of the union, which regulates and governs the interaction amongst member states and, ultimately, the harmonious functioning of the union as a whole.[384]

The concept was originally formalised and introduced into EU legislation by the Treaty of Rome but has subsequently been subsumed by The Treaty on the Functioning of the European Union ("TFEU").[385] The TFEU contains all the definitions

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[379] Piernas López JJ *The concept of state aid under EU law: from internal market to competition and beyond* (2015).
[380] Quigley C *European State Aid Law and Policy* 3rd edition. (2015)
[381] Quigley C *European State Aid Law and Policy* 3rd edition (2015).
[382] Binder T "European Union – The EU concept of state aid" (2020) *European Taxation* 60 (5).
[383] Derenne J & Verouden V "Distortion of competition and the effect on trade" in P Werner & V Verouden (eds) *EU State Aid Control. Law and Economics* (2016).
[384] Biondi A & Righini E "An evolutionary theory of state aid control" in D Chalmers & A Arnull (eds) *The Oxford Handbook of European Union Law* (2015).
[385] European Union "Consolidated version of the treaty on the functioning of the European Union" <https://www.refworld.org/docid/52303e8d4.html> (accessed 2021-04-28).

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of the relevant terminologies, outlines what is considered impermissible state aid, what is allowed within legal limits, how to apply for approval or exemptions, the process to follow when reporting potential state aid violations, and the possible consequences that may ensue after an investigation is concluded.[386]

The EC is the body responsible for overseeing the state aid framework, which is tasked with enforcing compliance.[387] The Commission has investigatory powers and the ability to refer cases to the European Court of Justice ("ECJ") for adjudication.[388] If the ECJ concludes that the subsidy or assistance received constitutes illegal state aid, the EC is compelled to require the member states concerned to abolish or alter such aid within a prescribed time period and the EU member states are further obligated to recover the lost revenue, which unduly benefited the specific undertaking.[389]

Unlawful state aid can be described as any form of assistance, subsidy or other aid provided by a government, public body, or publicly funded body, given to any undertaking that is engaged in any economic or commercial activity on a selective basis, which has the potential to distort competition and affect trade among the EU member states.[390]

The following requirements need to be satisfied before a supporting arrangement or regime can be regarded as state aid:[391]

1. the use of state resources;
2. the measure must confer an advantage to a certain undertaking;
3. the advantage must be selective in nature;
4. the measure must distort competition, or be likely to distort competition; and

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[386] Piernas López JJ *The concept of state aid under EU law: from internal market to competition and beyond* (2015).

[387] Department for Business Innovation and Skills "The state aid guide" <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31700/11-1040-state-aid-guide.pdf> (accessed 2021-04-28).

[388] Rutkiewicz K "The system of control and enforcement of state aid law in the European Union – the European Commission's powers and its co-operation with member states' courts in the years 2000-2010" (2012) 9 *Ekonomia I Prawo* 27-46.

[389] Quigley C *European State Aid Law and Policy* 3 ed (2015).

[390] Piernas López JJ *The concept of state aid under EU law: from internal market to competition and beyond* (2015).

[391] European Union "Consolidated version of the treaty on the functioning of the European Union" <https://www.refworld.org/docid/52303e8d4.html> (accessed 2021-04-28).

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5. the support must affect trade between member states or have the potential to do so.

If any of the above-mentioned requirements are not met, it will not be classified as impermissible state aid.[392]

3 6 2 2 The excess profit regime

The Belgian Income Tax Code 1992 ("BITC") contains and outlines the rules and principles that must be applied when calculating a person or entity's income tax liability in Belgium. According to Article 185(1) of the BITC, all companies are taxed on the total amount of their profits, including distributed dividends, regardless of whether it is a stand-alone company or part of a group. This constitutes the general position under Belgium law, but some exceptions exist. One of the most noteworthy is the so-called "excess profit regime". In essence, the scheme allowed companies to pay substantially less tax simply because they were part of a multinational group and could therefore benefit from suspected collaborations.[393] On the basis of tax rulings, the scheme exempted this so-called "excess profit" of a company from being subjected to taxation in Belgium.[394] The result of the aforementioned is double non-taxation, as this "excess profit" is actual recorded profit, which ends up not being taxed anywhere.

In 2004, Belgium introduced Article 185(2) of the BITC, which held that:

1. If a company that is part of a multinational group concludes cross-border transactions with another company, which is part of that group, under conditions that are different from those agreed between independent companies, the profit that the company would have made if it had been independent may be included in its profits.
2. If the profit of a company that is part of a multinational group includes profit, which was also included in the profit of another company of that group because of a

[392] Department for Business Innovation and Skills "The state aid guide" <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31700/11-1040-state-aid-guide.pdf> (accessed 2021-04-28).

[393] Blockx J "The Belgian excess profit exemption: tax incentives for multinational groups as state aid" (2017) 8 *Journal of European Competition Law & Practice* 25–26.

[394] Galendi Jr RA "State aid and transfer pricing: the inherent flaw under a supranational reference system" (2018) *Intertax* 46(12) 994-1010.

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rule such as that contained in part I above, then the profit of the first company will be adjusted in an appropriate manner.

According to the explanatory note accompanying the amendment, the objective of the legislation was to codify and entrench the purported "arm's length principle", which is especially applicable in transfer pricing transactions.[395] In addition, the Memorandum further stated that section II of the provision was intended to prevent the problem of double taxation from occurring.[396]

Undeniably, Article 185(2) of the BITC has the potential to reduce a qualifying company's tax liability in Belgium significantly.[397] However, before a company can make use of this provision, it is required to obtain an advance ruling from the Belgium Ruling Commission.[398] Evidence shows that such rulings were only granted if the said company could illustrate that the transaction would lead to new employment opportunities, skill development or a material investment in Belgium.[399] Under Belgium law, such a ruling is only available for transactions or arrangements which have not yet produced any tax consequences.[400]

In other words, the "excess profit" scheme allows special treatment of selected companies. It enabled the Belgian tax authorities to issue tax rulings to specific multinational companies ("MNCs"). These rulings artificially lowered the companies' tax base by deducting so-called "excess profit" from the company's taxable income.[401]

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[395] *Kingdom of Belgium and Magnetrol International v European Commission*.
De Broe L "The state aid review against aggressive tax planning: 'Always look a gift horse in the mouth'" (2015) *EC Tax Review* 6 290-293.
Soom A "Does the European Union Primary Law Require Member States to Make Corresponding Adjustments?" (2020) 29 *EC Tax Review* 97-103.
[396] *Kingdom of Belgium and Magnetrol International v European Commission*.
[397] Traversa E & Sabbadini PM "State-Aid Policy and the Fight Against Harmful Tax Competition in the Internal Market: Tax Policy in Disguise?" in W Haslehner, G Kofler & A Rust (eds) *EU Tax Law and Policy in the 21st Century* (2017) 107-134.
[398] Arena A "State Aids and Tax rulings: an assessment of the Commission's recent decisional practice" (2019) 1 *Market and Competition Law Review* 49-79.
[399] Hrushko N "Tax in the World of Antitrust Enforcement: European Commission's State Aid Investigations into EU Member States' Tax Rulings" (2017) 43 *Brooklyn Journal of International Law* 328.
[400] J Blockx "The Belgian excess profit exemption: tax incentives for multinational groups as state aid" (2017) 8 *JECL&P* 25-26.
[401] 25-26.

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The scheme hedges on the premise that MNC profits will always surpass that of a standalone company, notwithstanding that they operate under similar conditions.[402] The so-called "excess profit" allegedly results from the advantage derived from being part of a multinational group. This possibly includes but is not limited to, increased synergies and economies of scale.[403] Under the scheme, this "excess profit" is not taxed in Belgium, and the company's tax liability is reduced accordingly.[404]

Indisputably, Article 185(2) of the BITC is a very appealing incentive for large companies to invest in Belgium. However, Belgium's excess profit regime can possibly be regarded as unlawful state aid.[405] One can reach such a conclusion based on the following reasons: First, it deviates from the normal practices and principles contained in the BITC, which is used when determining a company's tax liability.[406] The regime provides those MNCs who are able to obtain such a tax ruling with a preferential, selective subsidy.[407] Especially compared to their competitors, which are liable to pay taxes in Belgium under the normal Belgian company tax laws.

Furthermore, even if one accepts the supposition that MNCs are uniquely positioned to generate an "excess profit", it ought to be shared amongst the group entities in a proportion that accurately reflects the economic reality.[408] This follows from the well-established arm's length principle,[409] which should be used when allocating profits between a group of companies at market terms.[410] However, under the Belgian scheme, the apparent "excess profit" is simply discounted unilaterally from the taxable income of a single group company.[411]

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[402] 25-26.
[403] Dirix K "Harmful tax competition: six Belgian tax incentives under the microscope" (2013) *EC Tax Review* 22 233-234.
[404] Blockx J "The Belgian excess profit exemption: tax incentives for multinational groups as state aid" (2017) 8 *Journal of European Competition Law & Practice* 25–26.
[405] *Kingdom of Belgium and Magnetrol International v European Commission*.
[406] De Broe L "The state aid review against aggressive tax planning: 'Always look a gift horse in the mouth'" (2015) *EC Tax Review* 6 290-293.
[407] Arena A "State Aids and Tax rulings: an assessment of the Commission's recent decisional practice" *M&CLR* 51.
[408] Blockx J "The Belgian excess profit exemption: tax incentives for multinational groups as state aid" JECL&P 25-26.
[409] Soom A "Does the European Union Primary Law Require Member States to Make Corresponding Adjustments?" *ECTR* 97-103.
[410] Galendi Jr RA "State aid and transfer pricing: the inherent flaw under a supranational reference system" (2018) *Intertax* 46(12) 994-1010.
[411] Dirix K "Harmful tax competition: six Belgian tax incentives under the microscope" *ECTR* 233-234.

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Lastly, despite the proclaimed objective of Article 185(2) of the BITC, the justification for preventing double taxation is unsubstantiated. In actual fact, it is evident that, in reality, the contrary is true. Due to the structure of the scheme, the discounted profits are neither taxed in Belgium nor in any other jurisdiction.[412] Moreover, the scheme does not even require companies to demonstrate any evidence of, or potential risk of, double taxation.[413] Instead of preventing double taxation, the scheme facilitates double non-taxation.

After the EC's enquiry was finalised in 2016, the Commission found that Article 185(2) of the BITC constitutes illegal state aid.[414] It should be noted that this investigation by the EC was limited to examining the scheme as a whole. Nevertheless, the Commission recommended that all beneficiaries be identified and that the illegitimate gains be recovered. However, the Belgium state and other applicants contested the EC's findings.

In 2019, the General Court of the EU concluded that the Commission had failed to demonstrate the existence of an aid scheme. Hence, the Commission's decision of 11 January 2016 was annulled in its entirety.[415] In particular, the General Court held that the Commission had not reviewed all the advance tax rulings issued, but only a sample of them. Thus, according to the General Court, the Commission had failed to prove that the Belgian tax authorities had followed a systematic approach in all the advance tax rulings.[416] Subsequent to this ruling, the EC instituted 39 separate, in-depth investigations on September 16, 2019, to assess whether the rulings granted

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[412] Hrushko N "Tax in the World of Antitrust Enforcement: European Commission's State Aid Investigations into EU Member States' Tax Rulings" (2017) *BJoIL* 328.

[413] Blockx J "The Belgian excess profit exemption: tax incentives for multinational groups as state aid" JECL&P 25-26.

Journal of European Competition Law & Practice 8 (1) 25–26.

[414] European Commission "Commission decision of 11.01.2016 on the excess profit exemption state aid scheme SA.37667 (2015/C) (ex2015/NN) implemented by Belgium <https://ec.europa.eu/competition/state_aid/cases/256735/256735_1748545_185_2.pdf> (accessed 2021-05-03).

[415] European Commission "Commission decision of 11.01.2016 on the excess profit exemption state aid scheme SA.37667 (2015/C) (ex2015/NN) implemented by Belgium <https://ec.europa.eu/competition/state_aid/cases/256735/256735_1748545_185_2.pdf> (accessed 2021-05-03).

[416] European Commission "Commission decision of 11.01.2016 on the excess profit exemption state aid scheme SA.37667 (2015/C) (ex2015/NN) implemented by Belgium <https://ec.europa.eu/competition/state_aid/cases/256735/256735_1748545_185_2.pdf> (accessed 2021-05-03).

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by Belgium between 2005 and 2014 under the Belgian excess profit ruling regime were indeed in breach of EU State aid rules.[417]

Notwithstanding the aforesaid, the ECJ Advocate General ("AG") Juliane Kokott has affirmed her support for the Commission's findings.[418] She recommended that the judgment be set aside, and the General Court should rule again on the actions brought by Belgium.[419]

According to the AG, the ECJ ought to find that the Commission has sufficiently demonstrated that the Belgian practice of making downward adjustments to profits of undertakings forming part of multinational groups does satisfy all the requirements to constitute an aid scheme.[420] The AG is further of the opinion that the EC's decision to analyse a batch of rulings rather than looking at all of them was justified. Moreover, she held that the Commission has sufficiently demonstrated that the sample used is representative overall, and therefore, adequate enough to establish a consistent administrative practice.[421]

3 6 2 3 Evaluating Belgium

At first glance, it is no surprise that Belgium is not the obvious choice or even on the shortlist for those searching for the ideal tax haven jurisdiction. However, if one considers the range of questionable and highly attractive tax incentives that were introduced over the years[422] and Belgium's slow response to implement anti-tax avoidance reforms,[423] it raises the question of whether this is just a facade. Or is there more to Belgium than one may think?

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[417] PricewaterhouseCoopers "EU commission opens formal investigation into 39 individual excess profit exemption related tax rulings in Belgium" <https://www.pwc.com/gx/en/tax/newsletters/eu-direct-tax-newsalerts/eudtg/pwc-eudtg-newsalert-25-sep-2019-eu-commission.pdf> (accessed 2021-05-03).
[418] Opinion of Advocate General Kokott (undated) *Concurrences* <https://www.concurrences.com/IMG/pdf/c-337_19_p_en.pdf?64785/b4aac2c5a524fa773449482e3871962432a6742b> (accessed 2021-05-03).
[419] Opinion of Advocate General Kokott (undated) *Concurrences*.
[420] Opinion of Advocate General Kokott (undated) *Concurrences*.
[421] Opinion of Advocate General Kokott (undated) *Concurrences*.
[422] Dirix K "Harmful tax competition: six Belgian tax incentives under the microscope" *ECTR* 233-234.
[423] European Commission "Reflections on the EU objectives in addressing aggressive tax planning and harmful tax practices" <https://www.ceps.eu/wp-content/uploads/2020/02/KP0419785ENN.en_.pdf> (accessed 2021-05-04).
The Brussels Times "Belgium: Tax haven and hell" <https://www.brusselstimes.com/news/magazine/47926/belgium-tax-haven-and-hell/> (accessed 2021-05-04).

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Even though Belgium has a relatively small geographic footprint, it is one of the densest populated countries in the world.[424] With a population of over 11.5 million people, it qualifies as a medium size country, even if it ranks among the smaller countries in this group. As previously discussed, a small geographic size and a small population are two of the main features that strongly correlate to tax haven status.[425] If one compares the aforementioned findings to typical tax havens, it is clear that for purposes of this evaluation, Belgium cannot be regarded as a small nation; hence, Belgium does not share those tax haven characteristics.

However, Belgium does fulfil the good governance requirement,[426] which also has statistical significance.[427] Moreover, it contains many of the supporting or related attributes that are associated with tax haven status.[428] The only aspects that are not applicable to Belgium is the requirement to have a common-law legal system and limited natural resources. Instead, Belgium uses a civil law legal system, and has moderate natural resources.[429] Thus, Belgium does not possess the typical tax haven characteristics nor conform to the perception of a tax haven. Notwithstanding the aforesaid, there is an argument to be made that based on the physical traits, it should

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[424] Britannica "Belgium" (undated) *Britannica* <https://www.britannica.com/place/Belgium > (accessed 05-05-2022).

[425] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1062. Kaufmann D Kraay A & Mastruzzi M "Governance matters IV: Governance indicators for 1996-2004" (2005) *World Bank Working Paper*

[426] The World Bank "Land area (sq-km) – United States" <https://data.worldbank.org/indicator/AG.LND.TOTL.K2?locations=US> (accessed 2021-05-05). World Wide Governance Indicators <https://info.worldbank.org/governance/wgi/Home/Reports> (accessed 2021-05-05); 2021 Index of Economic Freedom "Belgium" <https://www.heritage.org/index/country/belgium> (accessed 2021-05-05); Transparency International "Transparency International Belgium" <https://www.transparency.org/en/countries/belgium> (accessed 2021-05-05).

[427] Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1062; Kaufmann D Kraay A & Mastruzzi M "Governance matters IV: Governance indicators for 1996-2004" (2005) *World Bank Working Paper.* François R "Why should world governance be evaluated and for what purpose?" <https://www2.world-governance.org/IMG/pdf_WGI_full_version_EN.pdf> (accessed 2020-03-28).

[428] Trading Economics "Ease of doing business in Belgium" <https://tradingeconomics.com/belgium/ease-of-doing-business> (accessed 2021-05-06); Freedom House "Freedom in the World 2020: Belgium" <https://freedomhouse.org/country/belgium/freedom-world/2020> (accessed 2021-05-06); European Commission "Country information: Belgium" <https://ec.europa.eu/digital-single-market/en/country-information-belgium> (accessed 2021-05-06); EF English Proficiency Index "Belgium" <https://www.ef.com/wwen/epi/regions/europe/belgium/> (accessed 2021-05-06).

[429] Britannica "Belgium" (undated) *Britannica*.

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be possible for Belgium to become a tax haven. This is as a result of the close nature of some of the key attributes.

Apart from the physical qualities, it is vital to analyse Belgium's offering, and in particular, how it compares to the tax haven criteria.[430] The determination always commences with examining the tax rate. This on its own is not decisive, but it serves as a point of departure and provides a good indication of whether it is a tax haven or not.

Belgium has one of the highest tax rates in the world.[431] The standard corporate income tax rate is currently 25%.[432] This is considerably reduced from the highs of 33.99% prior to the legislative amendments,[433] as discussed below.[434] Before the recent changes, the rates also included a crisis tax. This levy has subsequently been abolished with the introduction of the revised rates.[435] In addition, there are special provisions available for smaller companies, which lower the applicable tax rates if all the requirements are met.[436]

For individuals, Belgium uses a progressive tax rate, which ranges anywhere between 25% and 50%.[437] Belgium further applies a residence-based system, which means that Belgium residents are taxed on their worldwide income, while the taxation

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[430] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998). Council of the European Union "Code of Conduct Group (Business Taxation)" ECOFIN Council on 29 November 1999; OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018); Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*.

[431] Organisation for Economic Co-operation and Development *Corporate tax statistics First Edition*

[432] PricewaterhouseCooper "Belgium: Corporate taxes on corporate income" <https://taxsummaries.pwc.com/belgium/corporate/taxes-on-corporate-income> (accessed 2021-05-06).

[433] Trading Economics "Belgium corporate tax rate" <https://tradingeconomics.com/belgium/corporate-tax-rate> (accessed 2021-05-06).

[434] Service Public Federal Finances <http://www.ejustice.just.fgov.be/eli/loi/2017/12/25/2017014414/moniteur#end> (accessed 2021-05-06).

[435] KPMG "Corporate income tax reform" <https://home.kpmg/be/en/home/insights/2017/08/corporate-income-tax-reform.html> (accessed 2021-05-06).

[436] Service Public Federal Finances <http://www.ejustice.just.fgov.be/eli/loi/2017/12/25/2017014414/moniteur#end> (accessed 2021-05-06).

[437] PricewaterhouseCoopers "Belgium: individual – taxes on personal income" <https://taxsummaries.pwc.com/belgium/individual/taxes-on-personal-income> (accessed 2021-05-06).

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for non-residents is limited to Belgium source income.[438] Based on the aforementioned, Belgium's income tax rates are certainly well above the global average.[439] More specifically, these rates constitute, or are very close to the upper boundary of the range. Hence, the first requirement of the tax haven criteria is not fulfilled.

The next requirement revolves around the exclusivity of the regime. If it is ascertained that the regime is entirely earmarked for non-residents, there is a strong likelihood that it is a tax haven. Or differently put, if the regime is ring-fenced from the domestic economy. Belgium does not offer a lower tax rate for non-residents, nor does it extend more favourable provisions to them.[440] Thus, the second requirement cannot be answered in the affirmative.

The third and fourth requirements focus on transparency and the exchange of information. If a jurisdiction is hesitant or uncooperative to participate in collecting and exchanging information, it is an early warning that said country is trying to conceal information. More often than not, such regime's appeal revolves around secrecy.

Belgium is both a member of the OECD and of the EU.[441] Belgium has participated in and cooperated with all the OECD's efforts to clamp down on harmful tax practices and tax haven jurisdictions alike.[442] Amongst others, Belgium has signed numerous DTAs, treaties and TIEAs.[443] Similarly, the EU has introduced their own set of measures to address tax avoidance, transparency enhancements and greater

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[438] KPMG "Belgium: Income tax" (2011) *KPMG* <https://home.kpmg/xx/en/home/insights/2011/12/belgium-income-tax.html > (accessed 2021-05-07).

[439] KPMG "Individual income tax table" <https://home.kpmg/za/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html> (accessed 2021-05-07); KPMG "Corporate tax table" <https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html> (accessed 2021-05-07).

[440] KPMG "Belgium: Income tax" (2011) *KPMG*.

[441] Organisation for Economic Co-operation and Development *Convention on the Organisation for Economic Co-operation and Development*; Shengen Visa Info "The European Union and countries in the EU" <https://www.schengenvisainfo.com/eu-countries/#:~:text=Belgium%20is%20a%20member%20country,Dutch%2C%20French%2C%20and%20German> (accessed 2021-05-07).

[442] Organisation for Economic Co-operation and Development Library "Belgium" <https://www.oecd-ilibrary.org/sites/887f6df8-en/index.html?itemId=/content/component/887f6df8-en> (accessed 2021-05-07).

[443] Global Forum on Transparency and Exchange of Information for Tax Purposes "Peer review report on the exchange of information on request: Belgium" <https://read.oecd-ilibrary.org/taxation/global-forum-on-transparency-and-exchange-of-information-for-tax-purposes-belgium-2018-second-round_9789264290839-en#page1> (accessed 2021-05-07).

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information sharing.[444] To this extent, Belgium has also gradually implemented all the EU's directives and recommendations, which gives effect to the aforesaid.[445] Therefore, one has to conclude that Belgium does not comply with either of the third or fourth requirements.

The fifth and final requirement pertains to substantial economic activity. If the advantages are available without any meaningful economic activity, it is generally an indication that the regime is purely tax driven. If the aforementioned is applied to Belgium, one finds that this requirement is not satisfied. For any person or entity to benefit from any of the tax incentives, it is a prerequisite that there must be a reasonable level of economic activity.[446] It is not specified what form this should take, but it will rather depend on the circumstances.

As is evident from the above analyses, if one applies a holistic perspective, one can conclude that Belgium does not fulfil the tax haven criteria. Thus, Belgium cannot be regarded as a tax haven jurisdiction. However, there are signs that everything may not be as simple as it would appear. Hence the question of whether these subtle signs are mere coincidence or is Belgium perhaps a quasi-tax haven?

Over the years, Belgium has introduced a range of very appealing tax offerings, which enabled entities to mitigate or reduce their tax liability. Some of the most

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444 European Commission "Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the international market" <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0026&from=EN> (accessed 2021-05-07); European Commission "Proposal for a Council Directive amending directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation" <https://eur-lex.europa.eu/resource.html?uri=cellar:89937d6d-c5a8-11e5-a4b5-01aa75ed71a1.0014.02/DOC_1&format=PDF> (accessed 2021-05-07); European Commission "Commission recommendation of 28.01.2016 on the implementation of measures against treaty tax abuse" <https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/company_tax/anti_tax_avoidance/c_2016_271_en.pdf> (accessed 2021-05-07); European Commission "Communication from the commission to the European parliament and the council" <https://eur-lex.europa.eu/resource.html?uri=cellar:b5aef3db-c5a7-11e5-a4b5-01aa75ed71a1.0018.02/DOC_1&format=PDF> (accessed 2021-05-07).

445 Loeff L "Implementation of the anti-avoidance directive in the Netherlands, Belgium and Luxembourg" <https://www.loyensloeff.com/media/476947/quoted-126nw.pdf> (accessed 2021-05-08).

446 Deloitte "Taxation and investment in Belgium 2017" <https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-belgiumguide-2017.pdf> (accessed 2021-05-08).

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noteworthy included the so-called excess profit regime, the notional interest deduction and the patent incentive regime.[447]

Upon a closer examination of these offerings, it is clear that the objective was to attract investment and to persuade companies to relocate their operations to Belgium, either partly or in its entirety. In exchange for the FDI, Belgium facilitated the reduction of said entities' tax obligations.[448] The excess profit regime for example, allowed certain companies to achieve a saving of between 50% to 90% on their tax bill.[449] The same is applicable to the other offerings, perhaps the only difference is the level of uptake, and the extent of the gains realised.

Many of these offerings caught the attention of either the EU or the OECD.[450] In a number of cases, the aforementioned bodies ruled against Belgium and subsequently ordered that the regime must either be reformed to comply with international best practice, or it must be totally abolished.[451]

Moreover, it appears that Belgium has constantly been sluggish or reluctant to implement the EU's policies, and to get on board with the OECD's initiatives,[452] especially pertaining to curbing tax avoidance and strengthening transparency and the exchange of information. Notwithstanding, at the end, Belgium always eventually makes the necessary amendments.

Based on the above discussion, it is apparent that Belgium does indeed function as a tax haven, while still being a member of the EU and the OECD. In this context, Belgium can be classified as a quasi-tax haven, even if it is limited to the specific

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[447] Dirix K "Harmful tax competition: six Belgian tax incentives under the microscope" *ECTR* 233-234.
[448] United Nations Conference on Trade and Development "Tax incentives and foreign direct investments" <https://unctad.org/system/files/official-document/iteipcmisc3_en.pdf> (accessed 2021-05-09).
Heimann B "Tax incentives for foreign direct investment in the tax system of Poland, the Netherlands, Belgium and France" <https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.546.6821&rep=rep1&type=pdf> (accessed 2021-05-09).
[449] Blockx J "The Belgian excess profit exemption: tax incentives for multinational groups as state aid" *JECL&P* 25-26.
[450] Dirix K "Harmful tax competition: six Belgian tax incentives under the microscope" *ECTR* 233-234.
[451] The Brussels Times "Belgium: Tax haven and hell" <https://www.brusselstimes.com/news/magazine/47926/belgium-tax-haven-and-hell/> (accessed 2021-05-10).
[452] The Brussels Times "Belgium: Tax haven and hell" <https://www.brusselstimes.com/news/magazine/47926/belgium-tax-haven-and-hell/> (accessed 2021-05-10).

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circumstances as outlined in the preceding section. For certain entities, it is possible to drastically reduce their tax assessments by utilising the available offerings. Among others, the excess profit regime is a prime example.[453]

To date, Belgium has revoked or amended most of these tax regimes, but whether this marks the end of such innovative offerings remains to be seen. If one looks at the past, a clear pattern indicates the contrary. It is very likely that Belgium will continue pushing the boundaries of what is permissible and introducing novel tax minimisation regimes.

3 7 The appeal of tax havens

Over the years, the popularity of tax havens has grown – as more options have become available for consumers,[454] the demand for tax havens and related services has also increased substantially.[455] Testimony of the former is the rapid growth of tax havens, the expanding footprint across the globe and their continuing perseverance.[456] Individuals and corporations alike have utilised the efficiencies and embraced the opportunities it offers.[457] This is despite the controversial nature, the potential negative consequences on the rest of the world and the mounting pressures to stop or limit their operations.[458]

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[453] Dirix K "Harmful tax competition: six Belgian tax incentives under the microscope" *ECTR* 233-234.
[454] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 160.
[455] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.
[456] Palan R "History of Tax Havens" <http://www.historyandpolicy.org/policy-papers/papers/history-of-tax-havens> (accessed 30-03-2022).
[457] G Zucman "The missing wealth of nations: Are Europe and the US net debtors or net creditors?" (2013) 128 *QJoE* 1321; Boston Consulting Group "Global Wealth 2017: Transforming the Client Experience" (13-06-2017) *Boston Consulting Group* <https://www.bcg.com/publications/2017/asset-wealth-management-financial-institutions-global-wealth-2017-transforming-client-experience> (accessed 30-03-2022); Tax Justice Network "New estimates for Missing Global Private Wealth, Income, Inequality and Lost taxes" <https://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf> (accessed 30-03-2022).
[458] https://www.bloomberg.com/news/articles/2013-05-03/offshore-tax-havens-in-spotlight-after-200-year-history> (accessed 2020-02-17).
[458] Tax Justice Network "Tax Havens & Financial Crisis" <https://www.taxjustice.net/topics/finance-sector/tax-havens-financial-crisis/> (accessed 2020-04-01); Baker R "Illicit financial flows from Africa: Their loss; not our gain" in O-H Fjeldstad & AJR Dahl (eds) *Lifting the veil of secrecy: perspectives on international taxation and capital flight from Africa* (2017) 58; Oxfam International "Inequality and poverty: the hidden costs of tax dodging" <https://www.oxfam.org/en/inequality-and-poverty-hidden-costs-tax-dodging> (accessed 2020-04-01); Tax Justice Network "The price of offshore revisited" <https://tjn-usa/storage/documents/The_Price_of_Offshore_Revisited _-_22-07-2012/> (accessed

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3 7 1 Attractive features

There are numerous reasons for the popularity and success of tax havens. In broad terms, this may include, but is not limited to the following: [459]

1. taxation;
2. good governance;
3. asset protection;
4. succession planning;
5. facilitating investments;
6. well-developed financial system;
7. ease of doing business;
8. advanced infrastructure;
9. modern legislation;
10. flexible regulatory requirements; and
11. innovative entity types.

The majority of the above-mentioned factors have been discussed in sufficient detail in paragraph 3 4 above. Those sections are repeated in the subsequent discussion. Only those elements that were not previously discussed elsewhere, are elaborated on.

For most, the protection of one's assets is of paramount importance. Similarly, is the freedom to decide on and determine what happens to one's property. Unfortunately, not everyone is as fortunate. In an attempt to circumvent these limitations and to safeguard their property against policies such as expropriation without compensation and forced heirship rules, individuals and entities alike transfer their wealth to tax havens.[460] Such policies may be implemented in one's home country for political reasons but may go against one's beliefs. Most tax haven

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2020-02-17); Dharmapala (2008) *ORoEP* 663; Pragua "Addressing tax evasion and tax avoidance in developing countries" (2010) *Tax Compact*; Meizner *Automatic exchange of information as the New Global Standard*; Vandenberg (2015) *ADBI* 3; Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 146; The Economist "Storm survivors" (14-02-2013) *The Economist*.

[459] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 160.
Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.
Bruner CM "Re-imagining offshore finance: Market-dominant small jurisdictions in a globalizing financial world" (2016) 21.

[460] Bruner CM "Re-imagining offshore finance: Market-dominant small jurisdictions in a globalizing financial world" (2016) 62-63.

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jurisdictions disregard such policies and will not offer assistance in the enforcement thereof.[461] This means that any property that is located within the tax haven will be outside the reach of such policies.

Moreover, tax havens are at the forefront of modernising legislation, especially with regard to commercial matters and legal entity types such as company and trust law.[462] Investors value the ability to adapt and innovate. Outdated, clumsy and complicated legislation hinders business activities and is not conducive to growth. Reviewing and reforming regulations and statutes enables the emergence of innovative products that can address a need or problem.

None of the aforementioned will be relevant in the absence of advanced and well-developed infrastructure. Without adequate infrastructure, many of the tax haven services are not feasible.[463]

3 7 2 Mauritius

Mauritius has recently solidified its position as a renowned investment destination, especially for the African region.[464] The combination of its geographic location, ease of doing business, attractive tax attributes and modern legislation makes it the preferred choice for many.[465] The trust structure is often used to facilitate investments into and through Mauritius.[466]

3 7 2 1 Taxation overview

Mauritius uses a residency-based tax system. Therefore, Mauritian residents are liable to tax on their worldwide income, and non-residents are liable to tax only on Mauritius source income.[467] The standard income tax rate for individuals is 15%, unless they

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461 Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.

462 Bruner CM "Re-imagining offshore finance: Market-dominant small jurisdictions in a globalizing financial world" (2016) 180.

463 Mara ER "Determinants of tax havens" (2015) 32 *PE & F* 1639.

464 Financial Times "Special Report: Investigating Mauritius" <https://www.ft.com/reports/investing-mauritius> (accessed 2020-04-02).

465 Monarch & Co "Benefits of investing" <http://monarchandco.com/mauritius/business/benefits-of-investing/> (accessed 2020-04-02).

466 Offshore Trusts Guide "Offshore trusts report: Mauritius" <https://www.offshoretrustsguide.com/report/mauritius_tax_treatment.asp> (accessed 2020-03-10).

467 Mauritius Revenue Authority "General Principles of Taxation" <https://www.mra.mu/index.php/taxes-duties/overview-of-taxes> (accessed 2020-04-02).

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earn below a certain threshold.[468] Similarly, the tax rate for corporate entities is also 15%.[469] However, there are exceptions for certain types or categories of entities, which can reduce this rate substantially, for example, the Global Business License ("GBL") regime.

The Income Tax Act 1995 ("MITA") classifies a trust as a company.[470] This means that legal personality is assigned to a trust within the ambit of the MITA. Or put differently, a trust is equated with a company for tax purposes. The consequences are that wherever a provision refers to a company, it should be read also to include a trust[471] unless the provision explicitly provides otherwise. The effect of the aforementioned is that a trust is liable for tax in its own right and treated as such.

Resident entities are liable to a 2% corporate social responsibility levy.[472] This is, however, not applicable to non-resident entities. Sales tax or VAT is payable on qualifying goods and services at a rate of 15%.[473] Provision has been made for exclusions and zero-rated goods.

In addition, there are no capital gains tax, stamp duty, estate duty, gift tax or wealth taxes payable in Mauritius.[474] Dividend taxes are limited to foreign dividends, for which a foreign tax credit can be claimed.[475] Similarly, this exemption is extended to trusts. This can be explained by the MITA equating a trust to a company. This means that all distributions by a trust are considered dividends for tax purposes.[476] Therefore, the income will be taxed in the hands of the trust but will be exempted in the hands of the beneficiaries. The normal flat rate of 15% will be applicable for the trust, unless it

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[468] KPMG "Mauritius budget highlights 2019/2020" <https://assets.kpmg/content/dam/kpmg/mu/pdf/mu-kpmg-mauritius-budget-highlights-2019-2020.pdf> (accessed 2020-04-02).
[469] Mauritius Revenue Authority "Corporate Taxation" <https://www.mra.mu/index.php/taxes-duties/corporate-taxation> (accessed 2020-04-02).
[470] Part I, s 2 of the Income Tax Act 1995.
[471] Imara Investing in Africa "A Guide to Mauritius Trusts" <https://www.scribd.com/document/307439568/A-Guide-to-Mauritius-Trusts> (accessed 2020-04-02).
[472] PKF "Africa Tax Guide" <https://www.pkf.com/media/10044266/pkf-africa-2019-2020_online.pdf> (accessed 2020-04-02).
[473] Mauritius Revenue Authority "Corporate Taxation" <https://www.mra.mu/index.php/taxes-duties/corporate-taxation> (accessed 2020-04-02).
[474] Mardemootoo SR "Mauritius: Law and practice" <https://practiceguides.chambers.com/practice-guides/corporate-tax-2020/mauritius> (accessed 2020-04-02).
[475] Mauritius Revenue Authority "Corporate Taxation" <https://www.mra.mu/index.php/taxes-duties/corporate-taxation> (accessed 2020-04-02).
[476] Part IV, s 46(4) of the Income Tax Act 1995.

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is a GBL entity. Where a resident beneficiary receives a distribution from a non-resident trust, that income will be treated as foreign source income.[477] For this reason, it will be taxable at the rate of 15% unless either the GBL exception is applicable or the beneficiary is an individual, and the income is not remitted to Mauritius.

Withholding taxes, at a rate of 15%, are only applicable if interest or royalties are paid to non-residents.[478] There are also exceptions to this rule. There is, however, land transfer tax and registration duty payable on the transfer of immovable property at 5%, respectively.[479]

Furthermore, with regard to trusts, there is no income exemption threshold or other relief measures available, unlike in the case of individuals.[480] This usually comprises the income threshold, education expenses for children, interest paid on housing loans, premiums paid on medical or health insurance, contributions made to an approved provident fund and solar energy investment allowance.[481] Trustees are, however, permitted to claim deductions for which the trust qualifies, as set out in the MITA.

Even though the trustee is the agent or representative taxpayer of the trust, it is not necessarily the trustees that are assessed. Depending on the circumstances, income derived from a trust can be taxed in the hands of the beneficiaries or the trust.[482] It is important to note that the MITA does not contain any attribution provisions, where the income derived by the trust is deemed to be that of the donor. This arguably stems from the fact that Mauritius does not impose any taxes on gifts or donations or

[477] PriceWaterhouseCoopers "Mauritius – Corporate – Taxes on Corporate Income" <http://taxsummaries.pwc.com/ID/Mauritius-Corporate-Taxes-on-corporate-income> (accessed 2020-04-03).

[478] Mardemootoo SR "Mauritius: Law and practice" <https://practiceguides.chambers.com/practice-guides/corporate-tax-2020/mauritius> (accessed 2020-04-02).

[479] PKF "Africa Tax Guide" <https://www.pkf.com/media/10044266/pkf-africa-2019-2020_online.pdf> (accessed 2020-04-03).

[480] Mauritius Revenue Authority "An outline of Mauritius income tax system" <http://www.mra.mu/download/OutllineofMauritiusIncomeTaxSystem.pdf> (accessed 2020-04-03).

[481] KPMG "Mauritius budget highlights 2019/2020" <https://assets.kpmg/content/dam/kpmg/mu/pdf/mu-kpmg-mauritius-budget-highlights-2019-2020.pdf> (accessed 2020-04-03).
Mauritius Revenue Authority "Corporate Taxation" <https://www.mra.mu/index.php/taxes-duties/corporate-taxation> (accessed 2020-04-03).
PKF "Africa Tax Guide" <https://www.pkf.com/media/10044266/pkf-africa-2019-2020_online.pdf> (accessed 2020-04-03).

[482] Imara Investing in Africa "A Guide to Mauritius Trusts" <https://www.scribd.com/document/307439568/A-Guide-to-Mauritius-Trusts> (accessed 2020-04-03).

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does not have any estate or inheritance taxes.[483] A further argument can be made that Mauritius aims to promote the use of trusts, especially offshore or non-resident trusts. If Mauritius had to tax the trust income in the hands of the founders or donors of such trusts, it would negate the advantages of the trust. The reason for the encouragement of offshore trusts, can be attributed to the massive FDI that enters the country. In addition, those trusts housing FDI are obligated to use Mauritian-based services, thus supporting the economy further. This all contributes positively to the goal of becoming the springboard into Africa and India.[484] Mauritius is trying to establish itself as the preferred investment destination. In the instance that assessments are raised on the beneficiaries, the normal income tax rates for individuals are applicable. In Mauritius, it has less of an effect on whether the income is taxed in the trust or in the hands of the beneficiaries. This can be attributed to the equal tax rate across the board, regardless of individual or entity type.[485] The only advantage for individual taxpayers to rather be taxed in their own hands instead of in the trust itself is the extensive range of exemptions and relief measures available to them.[486] It can further be argued that the lack of attribution provisions in Mauritius directly reflects the policy stance. This can be explained by the usual objective of attribution rules. The aim is never to benefit the taxpayer, but rather to form part of the anti-avoidance mechanisms. In other words, to curb tax avoidance. It is essential to remember that income will always only be taxed once. That is, either in the hands of the beneficiaries or the trust, but never both.

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[483] KPMG “Mauritius budget highlights 2019/2020” <https://assets.kpmg/content/dam/kpmg/mu/pdf/mu-kpmg-mauritius-budget-highlights-2019-2020.pdf> (accessed 2020-04-03).
Mauritius Revenue Authority “Corporate Taxation” <https://www.mra.mu/index.php/taxes-duties/corporate-taxation> (accessed 2020-04-03).
[484] How an idyllic African island became a tax haven for some of the world’s biggest corporations” (23-07-2019) *Quartz.*
[485] Mardemootoo SR “Mauritius: Law and practice” <https://practiceguides.chambers.com/practice-guides/corporate-tax-2020/mauritius> (accessed 2020-04-02).
KPMG “Mauritius budget highlights 2019/2020” <https://assets.kpmg/content/dam/kpmg/mu/pdf/mu-kpmg-mauritius-budget-highlights-2019-2020.pdf> (accessed 2020-04-03).
[486] Mardemootoo SR “Mauritius: Law and practice” <https://practiceguides.chambers.com/practice-guides/corporate-tax-2020/mauritius> (accessed 2020-04-02).

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3 7 2 2 Trust law

In Mauritius, a trust is not regarded as a separate legal entity but as a legal relationship between the settlor and the trustees.[487] A trust creates dual ownership where the legal title to the property is vested in one person, while the beneficial ownership to the same property is vested in another.[488] This allows the beneficial owner to effectively divest himself of direct or indirect ownership while still influencing the administration of the property.[489] The legal title is held by the trustees, or by someone else on their behalf, for the benefit of the beneficiaries. The trust property does not form part of their personal estate.[490]

In contrast to South Africa, no distinction is made between a *bewind* and ownership trust in Mauritius. For this reason, all trust forms are ownership trusts. The trust types are more specialised and are more ridged in form. The types of trusts found in Mauritius are as follows:

1. Discretionary trust – the basic principles are identical to those in South Africa, and this is the most widely used trust type for offshore trust purposes. The settlor typically provides a letter of wishes to the trustees as guidance for the administration thereof.[491] Beneficiaries do not have fixed entitlement or interest in the trust property. The trustees have the discretion to determine whether, to whom and how much of the assets, income and capital of the trust must be distributed to the beneficiaries.[492]
2. Vesting trust – The position is similar to that of South Africa. The beneficiaries have a real right to the trust income and/or the trust capital. The trustees have

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487 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. Signed on 1 July 1985 and came into operation on 1 January 1992.

488 Appleby "Guide to trusts in Mauritius" <https://www.applebyglobal.com/publication-pdf/guide/guide-to-trusts-in-mauritius-(februay-2015).pdf> (accessed 2020-04-03).

489 Imara Investing in Africa "A Guide to Mauritius Trusts" <https://www.scribd.com/document/307439568/A-Guide-to-Mauritius-Trusts> (accessed 2020-04-03).

490 Offshore Trusts Guide "Offshore trusts report: Mauritius" <https://www.offshoretrustsguide.com/report/mauritius_tax_treatment.asp> (accessed 2020-04-04).

491 Imara Investing in Africa "A Guide to Mauritius Trusts" <https://www.scribd.com/document/307439568/A-Guide-to-Mauritius-Trusts> (accessed 2020-04-04).

492 Appleby "Guide to trusts in Mauritius" (2015) *Appleby*.

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no discretion whether to, when or to who to make a distribution.[493] All distributions must be made as stipulated in the trust deed. This form of trust is far less encountered in practice. This may be attributed to the lack of separation of ownership and enjoyment, as experienced with other trust types.[494]

3. Purpose trust – the objects of a purpose trust are for the fulfilment of express purposes rather than specific beneficiaries or members of a class. The purpose can be of a charitable or non-charitable nature. There are specific requirements that must be complied with, and this includes the appointment of an enforcer.[495]
4. Protective or spendthrift trust – this trust type can be regarded as a form of asset protection. The terms of the trust may make the interest of a beneficiary subject to termination, restriction on alienation, diminution or suspension in a specified event such as insolvency, seizure or sequestration.[496]
5. Charitable trust – these trusts have the exclusive purpose or object beneficial to the public in general. This includes poverty relief, education, religion, environment or human rights.[497]
6. Constructive trust – these trusts are formed automatically when a trustee has breached a fiduciary duty. The profit or property obtained as a result of the breach shall be deemed to be held on trust on behalf of the person legally untitled thereto.[498]

Under Mauritian law, no forced heirship rules are applicable.[499] This means for non-resident settlors the transfer or disposition of property on trust will not be set aside, avoided or declared invalid as a result of any rule or law relating to succession or similar nature.[500]

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[493] Imara Investing in Africa "A Guide to Mauritius Trusts" <https://www.scribd.com/document/307439568/A-Guide-to-Mauritius-Trusts> (accessed 2020-04-04).
[494] The Trusts Act 2001, part III, section 16.
[495] Appleby "Guide to trusts in Mauritius" (2015) *Appleby*.
[496] Appleby "Guide to trusts in Mauritius" (2015) *Appleby*.
[497] Imara Investing in Africa "A Guide to Mauritius Trusts" <https://www.scribd.com/document/307439568/A-Guide-to-Mauritius-Trusts> (accessed 2020-04-04).
[498] Appleby "Guide to trusts in Mauritius" (2015) *Appleby*.
[499] Offshore Trusts Guide "Offshore trusts report: Mauritius" <https://www.offshoretrustsguide.com/report/mauritius_tax_treatment.asp> (accessed 2020-04-04).
[500] Appleby "Guide to trusts in Mauritius" (2015) *Appleby*.

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Trust affairs in Mauritius are significantly more private. It is not mandatory to register a trust in Mauritius.[501] However, it is possible to do so by lodging the trust deed with the registrar general. If registered, a confirmatory date of when the trust was created will be obtained.[502]

3 8 The effects of tax havens on the world

Whether the existence of tax havens is the downfall of the world, the greatest invention, or something in between, remains debatable. It probably depends on the perspective from which it is viewed. However, one thing is clear: the significance of tax havens in the global economy cannot be understated.

It is estimated that more than one third of FDI and more than half of all banking assets are routed through these financial networks.[503] Due to the nature of tax havens, quantifying the exact value of untaxed or lightly taxed income and wealth in these jurisdictions is nearly impossible. The current data varies drastically. The estimations range from a conservative $7.8 trillion[504] to a middling $10.3 trillion, [505] to as high as $21-32 trillion.[506] These amounts can increase annually with about 4%,[507] to a staggering 10%.[508]

The operational methodologies of these tax haven jurisdictions enable individuals and corporations to be "elsewhere, ideally nowhere" through legal spaces

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[501] Imara Investing in Africa "A Guide to Mauritius Trusts" <https://www.scribd.com/document/307439568/A-Guide-to-Mauritius-Trusts> (accessed 2020-04-04).
[502] Appleby "Guide to trusts in Mauritius" (2015) *Appleby*.
[503] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 62.
[504] Zucman (2014) *JoEP* 121; G Zucman "The missing wealth of nations: Are Europe and the US net debtors or net creditors?" (2013) 128 *QJoE* 1321.
[505] Boston Consulting Group "Global Wealth 2017: Transforming the Client Experience" (13-06-2017) *Boston Consulting Group*.
[506] Tax Justice Network "New estimates for Missing Global Private Wealth, Income, Inequality and Lost taxes" <https://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf> (accessed 2020-04-04).
[507] Boston Consulting Group "Global Wealth 2017: Transforming the Client Experience" (13-06-2017) *Boston Consulting Group*.
[508] Kar D & Spanjers J "Illicit financial flows from developing countries: 2002-2013" < http://www.gfintegrity.org/wp-content/uploads/2014/12/Illicit-Financial-Flows-from-Developing-Countries-2003-2012.pdf> (accessed 2020-04-04).

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created to duck regulations and controls of onshore countries.[509] This is made possible and facilitated by the regulatory framework.

3 8 1 The negative consequences

1. Unfair competition
2. Tax dodging
3. Criminal activities
4. Exacerbating inequality
5. Circumventing regulatory requirements
6. The resource curse
7. Undue influence

One of the strongest criticisms against tax havens, is the encouragement of unfair tax competition.[510] It is often put forward that the only way for other jurisdictions to compete for capital, is to also lower their taxes.[511] This, in turn, results in lower revenue and budgetary constraints.[512] This occurrence is known as the race to the bottom.[513]

According to the TJN unfair competition is not limited to jurisdictions, but applies to firm or company level. The unfair competition created by tax havens undermines smaller national companies.[514] This is because the larger international companies have the resources to exploit the benefits which tax havens offer. This is in contrast with smaller firms, which have no choice or means to reduce their tax burden.[515]

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[509] Palan R & Nesvetailova A "Elsewhere, ideally nowhere: shadow banking and offshore finance" (2013) 16 *Tidsskrifet Politik* 28.
[510] Avi-Yonah RS "Globalization, tax competition, and the fiscal crisis of the welfare state" (2000) 113 *HLR* 1573.
[511] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 217.
[512] Oxfam International "Public good or private wealth" <https://www.oxfam.org/en/research/public-good-or-private-wealth> (accessed 2020-04-05).
[513] Nov (2006) *VTR.*
[514] J Christensen, P Coleman & S Kapoor "Tax Avoidance, Tax Competition and Globalisation: making tax justice a focus for global activism" (2004) <https://www.researchgate.net/profile/John_Christensen8/publication/237424665_Tax_Avoidance_Tax_Competition_and_Globalisation_making_tax_justice_a_focus_for_global_activismi/links/588f46f945851567c9405eac/Tax-Avoidance-Tax-Competition-and-Globalisation-making-tax-justice-a-focus-for-global-activismi.pdf> ((accessed 2020-04-05).
[515] J Christensen, P Coleman & S Kapoor "Tax Avoidance, Tax Competition and Globalisation: making tax justice a focus for global activism" (2004) <https://www.researchgate.net/profile/John_Christensen8/publication/237424665_Tax_Avoidance_Tax_Competition_and_Globalisation_making_tax_justice_a_focus_for_global_activismi/links/588f46f945

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Compounding the problem further is the phenomenon of tax dodging.[516] This consists of tax avoidance and tax evasion.[517] The distinction between these terminologies and classifications are not as clear as one might think,[518] and in recent times this line has been further blurred.[519] It has been held that "[t]he difference between tax avoidance and tax evasion is the thickness of a prison wall".[520]

Even though the resulting effects of tax avoidance and tax evasion are the same, there are still noticeable differences,[521] the major being that tax avoidance is legal and tax evasion is not.[522] Recently, other terminology has emerged that aims to expand tax avoidance into subcategories further. For example, acceptable tax planning, tax mitigation and unacceptable tax planning.[523]

851567c9405eac/Tax-Avoidance-Tax-Competition-and-Globalisation-making-tax-justice-a-focus-for-global-activismi.pdf> (accessed 2020-04-05).

[516] Tax Justice Network "Tax Havens & Financial Crisis" <https://www.taxjustice.net/topics/finance-sector/tax-havens-financial-crisis/> (accessed 2020-04-07).
Baker R "Illicit financial flows from Africa: Their loss; not our gain" in O-H Fjeldstad & AJR Dahl (eds) *Lifting the veil of secrecy: perspectives on international taxation and capital flight from Africa* (2017) 58.
Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.
Tax Justice Network "The price of offshore revisited" <https://tjn-usa/storage/documents/The_Price_of_Offshore_Revisited _-_22-07-2012/> (accessed 2020-04-07).
Dharmapala (2008) *ORoEP* 663.
Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 146.
Knobel A "Trusts: weapons of mass injustice?" <https://www.taxjustice.net/wp-content/uploads/2017/02> (accessed 2020-04-05).
Oxfam International "Public good or private wealth" <https://www.oxfam.org/en/research/public-good-or-private-wealth> (accessed 2020-04-05).

[517] Oxfam International "Public good or private wealth" <https://www.oxfam.org/en/research/public-good-or-private-wealth> (accessed 2020-04-05).

[518] McBarnet M Legitimate rackets: Tax evasion, tax avoidance, and the boundaries of legality" (1992) 3 *TJHJ* 58.

[519] McLaren J "The distinction between tax avoidance and tax evasion has become blurred in Australia: why has this happened?" (2008) 3 *JoATTA* 162.

[520] Elliffe C "The thickness of the prison wall – when does tax avoidance become a criminal offence?" (2011) 17 *NZBQ* 442.

[521] Kumarasingam S "Tax avoidance and tax evasion explained and exemplified" <https://www.sataxguide.co.za/tax-avoidance-and-tax-evasion-explained-and-exemplified/> (accessed 2020-04-06). KPMG "Avoidance and evasion: different phenomena with different solutions?" <https://responsibletax.kpmg.com/page/avoidance-and-evasion-different-phenomena-with-different-solutions-> (accessed 2020-04-06).

[522] Croome et al *Tax Law: An Introduction* 188.

[523] Koekemoer A "Chapter 2: Taxation in South Africa" in M. Stiglingh et al (eds) *Silke South African Income Tax 2019* (2019) 17.

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Regardless of the terminology used, these practices collectively cost governments approximately $600 billion a year in lost corporate tax revenue.[524] Unfortunately, developing countries are the most significantly affected by tax avoidance or tax evasion practices.[525] The lack of appropriate legislation, a culture of non-compliance, limited tax reporting and low-tax education are partially to blame.[526] Unlike developed countries, developing countries derive a large part of their tax revenue from corporate taxation.[527] Low-income economies comprise a significant portion of the lost revenue, equating to around $200 billion.[528] This does not only constitute a bigger percentage of GDP than advanced economies but is also more than the estimated $150 billion received annually in foreign development assistance.[529]

Corporations are not the only beneficiaries. Individuals have stashed anything between $8.7 trillion to an astonishing total of up to $36 trillion in offshore jurisdictions.[530] With the leaks of prominent tax haven jurisdictions' confidential documents,[531] the true extent of offshore wealth has only come to the forefront in recent years. Besides the magnitude, it gave a glimpse of who is using tax havens. Unsurprisingly, the majority of individuals consist of the rich and powerful, with famous and prominent figures featuring high on various lists.

Based on the accumulative wealth stored in tax havens, it is estimated that the resulting global individual income tax losses can easily exceed $200 billion a year,

[524] Crivelli E et al "Base erosion, profit shifting and developing countries" (2015) *IMF Working Paper 15/118*. Cobham A & Petr J "Measuring Misalignment: The Location of US Multinationals' Economic Activity versus the Location of their Profits." (2017) 37 *Development Policy* 94.
[525] Cobham A "Tax evasion, tax avoidance and development finance" (2005) 129 *QEHWPS.*
[526] Oguttu AW "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *International Centre for Tax and Development Working Paper.*
[527] Oguttu AW "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *International Centre for Tax and Development Working Paper.*
[528] Shaxson N "Tackling tax havens" (2019) 56(3) *F&D*.
[529] Norwegian Reports "Tax havens and development" <https://www.cmi.no/publications/file/3470-tax-havens-and-development.pdf> (accessed 2020-04-07).
[530] Henry JS "Taxing tax havens: how to respond to the Panama papers" <https://www.foreignaffairs.com/articles/panama/2016-04-12/taxing-tax-havens> (accessed 2020-04-07).
Zucman G "How corporations and the wealthy avoid taxes (and how to stop them) <https://gabriel-zucman.eu/how-corporations-avoid-taxes/> (accessed 2020-04-07).
[531] The Panama Papers <https://www.icij.org/investigations/panama-papers/> (accessed 2020-04-07).
The Paradise Papers <https://www.icij.org/investigations/paradise-papers/> (accessed 2020-04-07).

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which is additional to the corporate total.[532] The result is that there is not enough funding for the developmental projects or for crucial service delivery expansion, which is required to grow the economy and eventually improve the lives of ordinary people.[533]

As a result of the abundance of illicit capital, it also opens the door for other criminal activities such as terrorism and money laundering.[534] This, coupled with the flexible regulatory regime and strong secrecy provisions, makes tax havens a potentially fertile ground for devious or unlawful activities.[535] The limited information required and collected by authorities and the lack of transparency are of the most compelling attributes in this regard.[536] Exacerbating the problem, is the misuse of opaque entities such as trusts, which further adds another layer between the perpetrators and beneficiaries.[537]

In addition, the flexible regulations facilitate the circumvention of other jurisdictions regulatory requirements.[538] This includes, but is not limited to taxation, beneficial ownership disclosures and financial services.[539] One of the most noteworthy consequences is the effect on the financial markets.[540] This is due to the bypassing of financial regulatory requirements and oversight measures, which are enacted to ensure stability and resilience.[541] By not adhering to the capital reserves and masking the true risks associated with these financial instruments, it jeopardises the entire system's stability.[542] This is one of the leading factors that caused the 2008 global

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532 Shaxson N “Tackling tax havens” (2019) 56(3) *F&D*.

533 World Finance “The true costs of tax avoidance” <https://www.worldfinance.com/strategy/the-true-costs-of-tax-avoidance> (accessed 2020-04-08).
International Consortium of Investigative Journalism “Explore documents: Luxembourg leaks” <https://www.icij.org/investigations/luxembourg-leaks/explore-documents-luxembourg-leaks-database/> (accessed 2020-04-08).

534 Mitchell A et al “No accounting for tax havens” <https://www.taxjustice.net/cms/upload/pdf/AABA.pdf > (accessed 2020-04-08).

535 Mitchell A et al “No accounting for tax havens” <https://www.taxjustice.net/cms/upload/pdf/AABA.pdf > (accessed 2020-04-08).

536 Shaxson N *Treasure Islands: Tax Havens and the Men Who Stole the World*.

537 Knobel A “Trusts: weapons of mass injustice?” <https://www.taxjustice.net/wp-content/uploads/2017/02> (accessed 10-04-2023).

538 Shaxson N *Treasure Islands: Tax Havens and the Men Who Stole the World*.

539 Oxfam International “Public good or private wealth” <https://www.oxfam.org/en/research/public-good-or-private-wealth> (accessed 10-04-2023).

540 Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 118.

541 Financial Stability Board “Global shadow banking monitoring report 2017”.

542 Mitchell A et al “No accounting for tax havens” *Tax Justice* <https://www.taxjustice.net/cms/upload/pdf/AABA.pdf> (accessed 10-04-2023).

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financial crisis and collapse.[543] This is once again made possible by the impenetrable veil of secrecy.

These jurisdictions have also been described as sovereignty for sale or legislators for hire. This stems from the notion that everything can be bought at the right price, even legislation or policy positions.[544] It is also related to the perception that tax haven jurisdictions will do anything to keep the corporates and individuals happy to ensure that their capital remains within the jurisdiction.[545]

As a result of the aforementioned, tax haven jurisdictions rob emerging markets of much-needed tax revenue[546] that could have been used for developmental projects.[547] Moreover, it distorts the true estimation of wealth and inequality in the world.[548] This is due to the large proportion of wealth sheltered offshore in secrecy jurisdictions.[549] Research has shown that inequality directly affects economic growth, political stability and socio-economic problems.[550] In addition, by utilising the tax haven offerings, the wealthy can get richer while the poor are just getting poorer. It has further been held that by removing tax havens, it will improve non-havens[551]

One will think that the abundance of capital will translate into a better life for all. At face value, this sounds like a logical and plausible conclusion. Unfortunately, this is not the case. Similar to resource-rich countries, tax havens also suffer from the so-

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[543] Shaxson N *Treasure Islands: Tax Havens and the Men Who Stole the World*.
[544] Mitchell A et al "No accounting for tax havens" *Tax Justice*.
Palan R "Tax havens and the commercialization of state sovereignty" (2002) 56 *IO* 153.
[545] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 127.
[546] Avi-Yonah RS "Bridging the north/South divide: international redistribution and tax competition" (2004) 26 *Michigan Journal of International Law* 374.
[547] Norwegian Reports "Tax havens and development" <https://www.cmi.no/publications/file/3470-tax-havens-and-development.pdf> (accessed 2020-04-07).
[548] N Shaxson, J Christensen & N Mathiason "Inequality: You don't know the half of it" <https://www.attac.at/fileadmin/_migrated/content_uploads/tjn_inequality2012.pdf> (accessed 2020-04-10).
[549] N Shaxson, J Christensen & N Mathiason "Inequality: You don't know the half of it" <https://www.attac.at/fileadmin/_migrated/content_uploads/tjn_inequality2012.pdf> (accessed 2020-04-10).
[550] Oxfam International "Public good or private wealth" <https://www.oxfam.org/en/research/public-good-or-private-wealth> (accessed 2020-04-10).
[551] Hines Jr JR "Do tax havens flourish?" (2005) 19 *TP & E* 69.
Slemrod J & Wilson JD "Tax competition with parasitic tax havens" (2006) *NBER Working Paper 12225.*

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called resource curse.[552] This phenomenon is also known as the paradox of plenty.[553] Typically, this paradox is attributed to abundant resources crowding out activities that improve economic outcomes.[554] In short, it refers to the notion that even though there are enough financial resources to put the country on a trajectory of rapid economic growth, it seldom outperforms countries with fewer resources.[555] If they can utilise the opportunity successfully, it can improve the lives of everyone so that enjoyment is shared equally among citizens.[556] In reality that is not the case. Instead, greed, self-enrichment and fighting for power become the order of the day. This means only a select few enjoy the benefit of the country's resources. Usually, it is the politicians and those close to the inner circle. There is further evidence that a mere expectation of excessive resources may be enough to trigger the effects of a resource curse, even if the actual resources never materialise.[557]

3 8 2 The positive consequences

1. Improved competition
2. Mobile capital
3. Facilitating investment
4. Escaping unjust laws
5. Commercial viability
6. Skills development
7. Accelerating innovation
8. Economic sustainability.

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[552] Harrington B "Why tax havens are political and economic disasters" <https://www.theatlantic.com/business/archive/2016/07/tax-haven-curse/491411/> (accessed 2020-04-10).
[553] Dauvin M & Guerrerio D "The Paradox of Plenty: a meta-analysis" (2017) 94 213.
[554] Leibbrandt A & Lynham J "Does the paradox of plenty exist? Experimental evidence on the curse of the resource abundance" 21 *EE* 339.
[555] Frankel JA "The natural resource curse: a survey" (2010) *NBER Working Paper No. 15836.*
[556] Oxfam Briefing Paper "Lifting the resource curse: How poor people can and should benefit from the revenues of extractive industries" <https://www-cdn.oxfam.org/s3fs-public/file_attachments/bp134-lifting-the-resource-curse-011209_4.pdf> (accessed 2020-10-26).
Van der Ploeg F "Natural resources: curse or blessing?" (2011) 49 *Journal of Economic Literature* 368.
[557] Frynas JG, Wood G and Hinks T "The resource curse without natural resources: expectations of resource booms and their impact" (2017) 116(463) 237.

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The benefits for an individual country to become a tax haven and the appeal for using tax havens have been adequately discussed in paragraphs 3 4 and 3 5 respectively. Therefore, this section will only provide a brief overview of the positive effects on the global community.

With the emergence of tax havens, more options became available for consumers. This means there is increased competition among jurisdictions for FDI. This has a positive effect on the affordability and efficiency of doing business. Even though taxation is important for attracting FDI,[558] the improved competition does not hedge on taxation alone. Instead, it is the complete offering, which sets jurisdictions apart from one another. This may include taxation, legal and regulatory framework, speciality services or geographic location.

In addition, the advent of tax havens is responsible for the reduction of the burden traditionally placed on mobile capital.[559] This stems from the progress made by the international community to achieve capital neutrality. Removing or limiting double taxation opened the door for capital to move more freely across state boundaries.[560] This means the cost and entry barrier associated with international trade is substantially reduced.[561] Due to increased cross-border activity, conduit-OFCs have emerged, which specialise in facilitating investments.[562]

Not only do tax havens appear to enjoy significantly higher economic growth than the global average,[563] the presence of tax havens can actually also increase tax revenue for other countries.[564] This can be explained by the two main effects that tax havens have on other jurisdictions. It is known as the leakage effect and the crowding effect.[565] Closely related, high-tax countries which are in the nearby vicinity of tax

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[558] Desai "Chains of ownership, tax competition and the location of multinational firms" in *Foreign Direct Investments in the Real and Financial Sector of Industrial Countries* 63.
Altshuler R "Has U.S. investment abroad become more sensitive to tax rates?" in JR Hines Jr. (ed). *International Taxation and Multinational Activity* (2001) 15.
Altshuler R & Grubert H "Taxpayer responses to competitive tax policies and tax policy responses to competitive taxpayers: recent evidence" (2004) 34 *TNI* 1351.
[559] Hong Q & M Smart "In praise of tax havens: international tax planning and foreign direct investment" (2010) 54 *EER* 82-95.
[560] Singh "Tax havens: all you need to know" (19-07-2022) *Investopedia*..
[561] Janeba (1995) *JoPE* 312.
[562] Garcia-Bernado, Takes & Heemskerk (2017) *SR* 2.
[563] Hines Jr JR "Do tax havens flourish?" (2005) 19 *TP & E* 77.
[564] Johannsen N "Imperfect tax competition for profits, asymmetric equilibrium and beneficial tax havens" (2010) 81 *JIE* 253-264.
[565] Johannsen N (2010) 81 *JIE* 254.

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havens, generally benefit from much higher investment levels.[566] Besides investment, it further leads to increased competition and robustness in financial sectors in surrounding jurisdictions.[567] Even more noteworthy is the assertion that the fear of a so-called race to the bottom is completely misplaced.[568]

Despite the controversy surrounding tax havens, it is unlikely that they will cease to exist. This can be attributed to the vital role tax havens play in certain sectors, such as insurance.[569] Without the framework provided by tax havens, these services would not be feasible or affordable. This means that due to the existence of tax havens, new industries and product offerings have emerged. On a consumer level, it has made such products more accessible to a wider range of income classes.

Tax competition also provides the opportunity for poorer countries to compete for capital, which otherwise would not have been available to them.[570] The Lucas paradox explains this notion.[571] Exacerbating the problem is that developing countries are net providers or exporters of capital.[572] This means that the little capital that they have tends to flow towards rich, developed countries.

A pertinent question has been raised: what would happen to those economies if they can no longer offer the financial and banking services that they are so dependent on?[573] Some tax havens derive up to 90% of their revenue from financial services.[574]

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[566] Hines Jr JR "Do tax havens flourish?" (2005) 19 *TP & E* 69.

[567] Rose AK & MM Spiegel "Offshore financial centres: parasites or symbionts?" (2005) *Federal Reserve Bank of San Francisco Working Paper*

[568] Hong & Smart (2010) 85.

[569] MacLaren J & J Passant "Tax havens: Do they have a future providing banking and financial services" (2010) *Canberra L. Rev.* 12.

[570] Singh "Tax havens: all you need to know" (19-07-2022) *Investopedia*.

[571] Lucas Jr RE "Why Doesn't Capital Flow from Rich to Poor Countries?" (1990) 80 *Am. ECON. Rev.* 92.

Alfaro L, Kalemli-Ozcan S & Volosovych V "Why doesn't capital flow from rich to poor countries? An empirical investigation" (2008) 90 *RE&S* 347.

Cohen D & Soto M "Why Are Poor Countries Poor? A Message of Hope Which Involves the Resolution of a Becker/Lucas Paradox" (2002) Ctr. for Econ. Policy Research, Discussion Paper No. 3528.

Clemens MA & Williamson JG "Where Did British Foreign Capital Go? Fundamentals, Failures, and the Lucas Paradox: 18701913" (2000) Nat'l Bureau of Econ. Research, Working Paper No. 8028.

[572] Ju J & Wei S-J "A solution to two paradoxes of international capital flows" (2006) Nat'l Bureau of Econ. Research, Working Paper No. 12668.

Montiel PJ "Obstacles to investment in Africa: explaining the Lucas Paradox" (2006) Paper presented at the *Realizing the Potential for Profitable Investment in Africa* 30.

[573] MacLaren & Passant (2010) 2.

[574] Hampton MP & J Christensen "Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-configuration of Global Finance" (2002) 30(9) *WD* 1658.

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It may be that they will join the queue of countries seeking foreign aid to sustain themselves. It should be remembered that countries that can become tax havens are typically small in size and have limited natural resources.[575] This means that there are few viable economic sectors available which can generate sufficient revenue.

3 8 3 Mauritius

In recent years, South Africa was dethroned by the island nation of Mauritius in terms of per capita income, and Mauritius is also quickly becoming the preferred investment destination into Africa,[576] a position that had been associated with South Africa.[577] The worst part is that it is not just limited to foreign investors or domestic companies, which elect to shift their operations to Mauritius, but individuals as well.[578]

According to the TJN, Mauritius is among the world's worst tax havens.[579] This is due to its detrimental effect on Africa's tax collection and resulting budget deficits.[580]

Adding to the woes, Mauritius is attracting many highly skilled professionals and young entrepreneurs from South Africa.[581] This further contributes to the loss of wealth, brain drain, shrinking tax base and loss of tax revenue, which exacerbates existing challenges and problems.

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575 Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1060.
576 Financial Times "Mauritius rides wave of Asian investments in Africa" <https://www.ft.com/content/929f41d0-75b3-11e6-bf48-b372cdb1043a> (accessed 2020-04-08).
577 AFRASIA "AFRASIA South Africa Wealth Report 2019 <https://e.issuu.com/embed.html?u=newworldwealth&d=south_africa_2019> accessed 2020-04-08).
578 Butchart G "Why holiday island Mauritius is out-investing SA, and what we need to do about it" <https://www.dailymaverick.co.za/article/2019-04-16-why-holiday-island-mauritius-is-out-investing-sa-and-what-we-need-to-do-about-it/#gsc.tab=0> (accessed 2020-05-10).
Fitzgibbon W "Treasure Island: leak reveals how Mauritius siphons tax from poor nations to benefit elites" <https://www.icij.org/investigations/mauritius-leaks/treasure-island-leak-reveals-how-mauritius-siphons-tax-from-poor-nations-to-benefit-elites/> (2020-05-10).
579 Etter-Phoya R "The UAE and Mauritius are the most corrosive corporate tax havens against African countries – Tax Justice Network Africa" <https://www.taxjustice.net/2019/05/30/the-uae-and-mauritius-are-the-most-corrosive-corporate-tax-havens-against-african-countries-tax-justice-network-africa/> (accessed 2020-05-11).
580 Kiruga M "How Mauritius is mortgaging Africa's future" <https://www.theafricareport.com/15677/how-mauritius-is-mortgaging-africas-future/> (accessed 2020-04-11).
581 Kiruga M "How Mauritius is mortgaging Africa's future" <https://www.theafricareport.com/15677/how-mauritius-is-mortgaging-africas-future/> (accessed 2020-04-11).
Leon J "Mauritius now more than just a tax haven for South Africans" <https://www.miningreview.com/investment/mauritius-more-than-just-tax-haven-for-south-africans/#:~:text=The%20number%20of%20South%20Africans,greater%20financial%20and%20tax%20security.> (2020-05-12).

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It is estimated that South Africa is a net exporter of capital.[582] This means that more capital leaves the country than enters it. A distinction should be made between legitimate capital flight and illicit capital flight.[583] The latter is said to be the biggest pernicious global development of this century.[584] Over the last few years, billions of rands have left the country.[585] Besides the legitimate capital flows, the extent of illicit flows is difficult or nearly impossible to pinpoint. The Global Financial Integrity report estimates the loss in tax revenue to be billions of rands, with total capital flight round about the one trillion mark.[586] This translates to more than 7,6% of the South African economy.[587]

3 9 Combatting tax havens

The OECD was one of the first organisations to recognise the harm caused by tax havens and their threat to the global economy.[588] The OECD launched a comprehensive action plan in response to this rising threat. It was originally known as the Harmful Tax Competition Initiative[589] but was subsequently renamed to the Harmful Tax Practices Initiative.[590]

On the one hand, the project was intended "to develop a better understanding of how tax havens and HPTR, collectively referred to as harmful tax practices, affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally".[591]

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582 Trading Economics "South Africa – Foreign direct investment, net outflows (% of GDP)" <https://tradingeconomics.com/south-africa/foreign-direct-investment-net-outflows-percent-of-gdp-wb-data.html> (accessed 01-06-2019).

583 Oguttu AW "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *International Centre for Tax and Development Working Paper.*

584 Oguttu AW "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *International Centre for Tax and Development Working Paper.*

585 Schüssler M "Tragic data shows capital fleeing along with jobs" <https://www.moneyweb.co.za/moneyweb-opinion/soapbox/tragic-data-shows-capital-fleeing-along-with-jobs/> (accessed 01-06-2019).

586 Global Financial Integrity Report *Illicit Financial Flows to and from 148 Developing Countries: 2006-2015* January 2019.

587 Global Financial Integrity Report *Illicit Financial Flows* 47.

588 Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).

589 Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).

590 OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).

591 Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).

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The objective was to discourage the use of preferential tax regimes for foreign investors and to encourage transparency, international co-operation and effective information exchange among the tax authorities of different countries.[592] The strategy revolved around exposing tax haven jurisdictions. It sought to pressure countries into committing adequate reforms by shining the spotlight on the culprits and thereby increasing public scrutiny. If the ensuing negative attention and reputational damage did not deliver the desired outcome, the OECD reverted to threatening those jurisdictions with sanctions.

In broad terms, the initiative is comprised of three key areas:[593]

1. to identify and eliminate harmful features of preferential tax regimes in OECD member countries;
2. to identify "tax havens" and seek their commitments to the principles of transparency and effective exchange of information; and
3. to encourage other non-OECD countries to join the movement.

3 9 1 The OECD's black list of 2000

Based on the OECD's criteria for tax havens, as discussed in paragraph 3 2 2, and that of HPTRs, as discussed in paragraph 3 2 3, the OECD compiled and published a list of potential tax haven and HPTR jurisdictions.

The OECD initiative initially identified 47 possible tax havens, but six of these were found not to qualify.[594] Six of the remaining 41 tax havens had made commitments to cooperate and reform, leaving 35 jurisdictions on the first version of the published black list.

The OECD also evaluated the tax regimes of member countries. This produced a list of 47 potentially harmful regimes in 20 OECD countries.[595] After the review process was concluded, it was reported that these regimes had either been abolished

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[592] Organisation for Economic Co-operation and Development Library *Harmful Tax Competition* (1998).
[593] Organisation for Economic Co-operation and Development Library *The OECD's Projects On Harmful Tax Practices: 2006 Update On Progress In Member Countries* (2006).
[594] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).
[595] Organisation for Economic Co-operation and Development *2000 Progress Report: Towards Global Tax Co-operation: Progress in Identifying and Eliminating Harmful Tax Practices* (2000).

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in the meantime or were not harmful,[596] with the exception of holding company regimes, which were still being assessed. Holding company regimes were later reviewed, and it was concluded that these regimes were either not harmful or had been withdrawn except that of Luxembourg.[597]

In addition, the initiative also identified a range of possible defensive measures that could be taken against the tax havens. This included, but was not limited to, disallowance of deductions and credits, enhanced audit and enforcement, higher withholding taxes and imposition of transactional charges.

The publication of the black list unleashed an array of reactions from the effected parties – ranging from moderate to severe. The targeted countries were outraged at the initiative – accusing the OECD of neo-colonialism since they were being held up to standards, which were established without their participation. Moreover, development and economic sustainability concerns were raised by smaller tax havens, for example, those in the Caribbean and Pacific. As a consequence of the black list, these jurisdictions anticipated a crushing of their financial centres. The OECD was projected with a "big bully syndrome since many OECD member states that are major tax havens themselves avoided the blacklist".[598] This led many to question the objectivity of the process, often sighting political interference.[599]

In response to the black list, the tax havens and their lobbyists formed the International Tax and Investment Organization ("ITIO"), to mobilise a counter offence framing the OECD as being against the efficiencies created by competition.[600] Many others highlighted the lack of democratic decision making and participation in the process. It was further argued that the OECD is not the correct body to handle this matter but rather that the United Nations ("UN") is the appropriate forum for eliminating harmful tax practices.[601]

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[596] Organisation for Economic Co-operation and Development *The OECD's projects on harmful tax practices: 2004 update on progress in member countries* (2004).

[597] Organisation for Economic Co-operation and Development Library *The OECD's projects on harmful tax practices: 2006 update on progress in member countries* (2006).

[598] Shaxon N & J Christensen "Tax competitiveness- a dangerous obsession" in T Pogge & K Mehta (eds) *Global Tax Fairness* (2016) 265-266.

[599] T Tax Justice Network "Identifying tax havens and offshore finance centres" (2007) *Tax Justice Network*.

[600] Organisation for Economic Co-operation and Development *The OECD's projects on harmful tax practices: 2004 update on progress in member countries* (2004).

[601] Hishikawa A "The death of tax havens" (2002) 25 *Boston College International and Comparative Law Review* 390.

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Adding to the woes, the USA backtracked on the question of tax havens,[602] publicly expressing their disapproval of the OECD's initiative and rather echoing the language of the tax haven supporters.[603] Advocating that tax havens and tax competition force efficiency. The USA, therefore, joined the list of other prominent countries,[604] such as Switzerland and Luxembourg, in opposing and distancing themselves from the OECD's initiative.[605]

After the publication of the initial black list, in reaction to the criticism received, the OECD decided to increase participation and enhance the transparency of the process. This resulted in the establishment of the OECD Global Forum on Taxation ("GFT").[606]

Following from the former, the OECD's criteria were further diluted. The OECD dropped "zero tax rates" and 'lack of substantial activities' from the factors used to identify jurisdictions.[607] The shift from a tough stance to a soft approach had begun, as uncooperative tax havens were to be determined only on the basis of the remaining criteria of transparency and effective exchange of information.[608] The proposals for internationally coordinated sanctions also faded into the background.

The OECD called upon those jurisdictions that appeared on the black list to make public commitments to improve transparency and establish effective information exchange protocols. Unfortunately, the focus was not on the implementation, but rather just a commitment was adequate. Some attributed the abrupt loss of enthusiasm to a so-called newfound "cosy relationship between the OECD

[602] Carroll A "US ambivalence grows towards OECD initiative" in W Vleck (ed) *Offshore Finance and Small States: Sovereignty, Size and Money* (2001) 360.
[603] Shaxon N & J Christensen "Tax competitiveness- a dangerous obsession" in T Pogge & K Mehta (eds) *Global Tax Fairness* (2016) 265-266.
[604] Kurdle RT "U.S. defection from the OECD "Harmful Tax Competition" project: rhetoric and reality <https://www.files.ethz.ch/isn/21934/Kudrle.pdf> (accessed 2020-05-14).
[605] Organisation for Economic Co-operation and Development Library "Harmful tax competition" <https://www.oecd-ilibrary.org/taxation/harmful-tax-competition_9789264162945-en> (accessed 2020-05-17).
[606] Sharman JC *Havens in a Storm* (2006) 149.
[607] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).
[608] RT Kudrle "The OECD's harmful tax competition initiative and the tax havens: from bombshell to damp squib" (2008) 8 *GEJ* 1.

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membership and tax havens".[609] Even though the implementation was scarce, the same culprits were now considered as participating partners.[610]

3 9 2 The OECD's black-, grey- and white lists of 2009

After the largely unsuccessful outcomes of the black list of 2000, the OECD decided to revive the compilation process. This came about as a result of mounting pressure from the Group of Seven ("G7") countries. The G7 was dissatisfied with the slow pace of reform among the tax haven countries, even after they had committed to implementing the OECD's recommendations.[611] Exacerbating the pressure on the OECD was the public consternation of several tax scandals involving financial institutions in prominent OECD member countries – Liechtenstein and Switzerland.[612] The issue of tax havens was even under scrutiny at the summit of the Group of Twenty (G20) leaders, where it was resolved that: "Tax authorities, drawing upon the work of relevant bodies such as … the OECD, should continue efforts to promote tax information exchange. Lack of transparency and a failure to exchange tax information should be vigorously addressed."[613]

Coinciding with the former and contributing to the momentum, the global financial crisis caused havoc around the world. This enhanced pressure on the tax havens in numerous ways.[614] The permissive behaviour of tax havens was depicted as a substantial contributor to the crisis.[615] Their weak regulation facilitated the development and worldwide dispersion of opaque and risky financial products and made it difficult to assess the financial health of financial institutions having activities and assets in these centres.[616] As Western governments' fiscal difficulties mounted, the appetite to recover lost tax revenue from tax havens grew correspondingly.

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[609] Lesage D "The G20 and tax havens: maintaining the momentum?" (2010) *Governing the Global Economy: The Role of the G20 Conference Paper.*
[610] Organisation for Economic Co-operation and Development Library "The OECD's projects on harmful tax practices: 2006 update on progress in member countries".
[611] Kubosova L "EU states crack down on tax evasion" <https://euobserver.com/economic/26976> (accessed 2020-05-20).
[612] Kubosova L "EU states crack down on tax evasion" <https://euobserver.com/economic/26976> (accessed 2020-05-20).
[613] G20 "Declaration: summit on financial markets and the world economy" <http://www.g20.org/Documents/g20 summit declaration.pdf> (accessed 2020-05-20).
[614] Financial Stability Board "Global shadow banking monitoring report 2017".
[615] Shaxson *Treasure Islands: Tax Havens and the Men Who Stole the World*.
[616] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 85.

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Moreover, governments found it no longer acceptable that, while bailing them out, certain banks helped their clients to re-route money to tax havens or even operated through tax havens themselves.[617]

Shortly after the commencement of the Obama administration, the USA flip-flopped on their position, echoing the sentiment of the G7 – calling for tougher actions against tax havens.[618]

In the run-up to the G20 London summit, the pressure mounted as countries intensified the tax haven crackdown.[619] This led to the unprecedented move in which tax havens such as Switzerland, Liechtenstein, Luxembourg and Monaco announced that they would commit to the OECD's fiscal transparency standards provided that the requesting state could show indications of fraud.[620] This was a major departure from their vigorous opposition to the initiative previously.

This time around, the OECD published three lists:[621]

1. a white list of countries that had fully implemented the OECD standards;
2. a grey list of countries that have committed but have not substantially implemented the reforms; and
3. a black list of renegade countries.

In order for a country to be eligible to appear on the white list, the following criteria had to be satisfied:[622]

1. Exchange of information on request where it is "foreseeably relevant" to the administration and enforcement of the domestic laws of the treaty partner.

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[617] Financial Stability Board "Global shadow banking monitoring report 2017".
Palan R & Nesvetailova A "Elsewhere, ideally nowhere: shadow banking and offshore finance" (2013) 16 *Tidsskrifet Politik* 28.

[618] The Guardian "Obama bid to stamp out tax havens" <https://www.theguardian.com/business/2009/mar/04/obama-tax-haven-crackdown> (accessed 2020-05-23).

[619] G20 "Declaration: summit on financial markets and the world economy" <http://www.g20.org/Documents/g20 summit declaration.pdf> (accessed 2020-05-23).

[620] Willis A "Switzerland, Austria and Luxembourg relax banking secrecy" <https://euobserver.com/economic/27775> (accessed 2020-05-23).

[621] Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).

[622] Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).

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2. No restrictions on exchange caused by bank secrecy or domestic tax interest requirements.
3. Availability of reliable information and powers to obtain it.
4. Respect for taxpayers' rights.
5. Strict confidentiality of information exchanged.

At the London summit, the G20 leaders vowed "to take action against non-cooperative jurisdictions, including tax havens. We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over".[623]

The G20 countries proposed the following actions and sanctions to be used against non-cooperating jurisdictions:[624]

1. increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving non-cooperative jurisdictions;
2. withholding taxes in respect of a wide variety of payments;
3. denying deductions in respect of expense payments to payees resident in a non-cooperative jurisdiction;
4. reviewing tax treaty policy;
5. asking international institutions and regional development banks to review their investment policies; and,
6. giving extra weight to tax transparency and information exchange principles when designing bilateral aid programmes.

Due to the inherent complexities of evaluating compliance with the OECD's criteria, the GFT made a concession for inclusion on the white list. Instead of embarking on the fact-finding and reporting mission, which will make the assessment possible, they rather held that mere substantial implementation is adequate.[625] This meant that for a country to be eligible for inclusion on the white list, the jurisdiction only had to conclude twelve bilateral agreements with other countries containing a provision for information

[623] G20 "Global plan for recovery and reform: the Communique from the London Summit" <http://www.londonsummit.gov.uk/en/summit-aims/summit-communique> (accessed 2020-05-21).
[624] G20 "Declaration on strengthening the financial system <http://www.g20.org/Documents/Fin Deps Fin Reg Annex 020409 - 1615 final.pdf> (accessed 2020-05-21).
[625] Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).

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exchange.[626] Furthermore, the original requirement that the information exchange agreements must be with OECD countries also fell away. No explanation was provided for the arbitrary number of agreements.

The white list contained 40 jurisdictions – featuring most OECD countries but also well-known tax havens such as Jersey, the Isle of Man and Mauritius.[627] The UK was also included, regardless of its prominence in the offshore financial markets. The grey list contains the jurisdictions that have committed to the internationally agreed tax standard but have not yet substantially implemented the reforms. This list contained 30 tax havens, as set out in the definition discussed in paragraph 3 2 2. It further included eight financial centres such as Chile, Singapore, Belgium, Luxembourg, Austria and Switzerland.[628] Notwithstanding, the latter four European countries had already announced to comply with the threshold of twelve agreements in the near future.[629] Finally, the black list featured four jurisdictions that have not committed to the internationally agreed tax standard: Costa Rica, Malaysia (Labuan), the Philippines, and Uruguay.[630]

The publication of the OECD lists did not go without power politics. Instead, a similar situation unfolded as it did in the early 2000s. A political battle ensued between dominant world leaders, each advocating to safeguard their own interest and promoting their approach.[631] The UK knew that without an agreement, the whole conference would collapse, and politically this was not an option. In order to keep the harmony and prevent the initiative from collapsing, serious concessions were made.[632] The conflict arising between European countries such as France and Germany, on the

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[626] Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).
[627] Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).
[628] Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).
[629] Willis A "Switzerland, Austria and Luxembourg relax banking secrecy" <https://euobserver.com/economic/27775> (accessed 2020-05-23).
[630] Organisation for Economic Co-operation and Development *Tax co-operation 2010: Towards a level playing field* (2010).
[631] Watt N et al "G20 declares door shut on tax havens" <: http://www.guardian.co.uk/world/2009/apr/02/g20-summit-tax- havens> (accessed 2020-05-23).
[632] Wintour P, N Watt & Borger J "G20 summit: late night hotel peace talks that rescued deal" <http://www.guardian.co.uk/world/2009/apr/03/g20- sarkozy-obama-hotel-talks> (accessed 2020-05-25).

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one hand, as well as China, was one of the biggest sticking points.[633] With the intervention of the USA, eventually, Chinese pressures kept Hong Kong and Macau out of the black list, despite satisfying the criteria. Instead, they were merely mentioned as a side note to China, in the white list as "excluding the Special Administrative Regions which have committed to implement the internationally agreed tax standard".[634] While the OECD asserts that Hong Kong and Macau are not tax havens according to the OECD's definition, that both have committed to the standard and set out a timetable to implement it, and that the GFT will observe both.[635] Equally, Austria, Belgium and Luxemburg were not amused that the EU allowed the publication of these lists, while the three countries had already announced substantial implementation. This conflicted with the prior EU language.[636] The UK was one of the prominent activists who called for harsher action and for measures to be intensified to curb tax havens.[637] They even went so far to warn people that their money in tax havens would no longer be safe. They hailed the progress made and declared that with the new measures in place, it was the end of bank secrecy.[638] This strong stance is somewhat of an irony, given the enabling and facilitating role the UK played and continues to play in the emergence and perseverance of tax havens.[639] Not to mention that the crown territories and dependencies are the worse culprits, but for some reason, still receive the support of the UK.[640] In addition, the G20 agreed to only take note of the OECD's

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[633] Watt N et al "G20 declares door shut on tax havens" <http://www.guardian.co.uk/world/2009/apr/02/g20-summit-tax- havens> (accessed 2020-05-25).
[634] Mason P "The strange case of Macau, the tax haven the disappeared" <https://www.bbc.co.uk/blogs/newsnight/paulmason/2009/04/the_strange_case_of_macau_the.html> (accessed 2020-05-24).
[635] Organisation for Economic Co-operation and Development *Countering offshore tax evasion. Some questions and answers on the project* (2009).
[636] Skander N et al "The EU in the G8 System: assessing EU member states involvement" (2009) *EUI Working Paper RSCAS 2009/45.*
[637] Watt N et al "G20 declares door shut on tax havens" <: http://www.guardian.co.uk/world/2009/apr/02/g20-summit-tax- havens> (accessed 2020-05-24).
[638] Watt N et al "G20 declares door shut on tax havens" <: http://www.guardian.co.uk/world/2009/apr/02/g20-summit-tax- havens> (accessed 2020-05-24).
[639] Shaxson "Tax havens: Britain's second empire" (29-09-2019) *Tax Justice*.
[640] The Guardian "UK and territories are 'greatest enabler' of tax avoidance, study says" <https://www.theguardian.com/world/2019/may/28/uk-and-territories-are-greatest-enabler-of-tax-avoidance-study-says> (accessed 2020-05-24).

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lists, but not to endorse them in any way.[641] This was not the case for the UN, which also adopted the OECD's standard for its tax work.[642]

Very soon after the London summit of G20, the truncated black list was also emptied completely, with the four jurisdictions committing to the standards.[643] Swiftly thereafter, the majority of countries on the grey list committed to implementing the OECD's standards, which saw them move to the white list. By this time, only nine tax havens and five financial centres remain on the grey list.[644]

The Group of Eight ("G8") countries further echoed the call to clamp down on tax havens. They instructed that the OECD should reform the GFT and expand participation.[645] Responding to the requests of the G8, the GFT started a three-year peer-review process to monitor both jurisdictions' regulatory frameworks and the concrete implementation of the standard. The arbitrary criteria used for entry to the white list were also flagged as a matter that requires review.[646] Moreover, the GFT became more attentive to stronger involvement of developing countries "to make it easier for developing countries to secure the benefits of a new cooperative tax environment".[647] The GFT further continuously investigates additional possibilities for multilateral agreements in the world.[648]

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641 Mason P "The strange case of Macau, the tax haven the disappeared" <https://www.bbc.co.uk/blogs/newsnight/paulmason/2009/04/the_strange_case_of_macau_the.html> (accessed 2020-05-26).
Wintour P, N Watt & Borger J "G20 summit: late night hotel peace talks that rescued deal" <http://www.guardian.co.uk/world/2009/apr/03/g20- sarkozy-obama-hotel-talks> (accessed 2020-05-26).

642 Organisation for Economic Co-operation and Development *Promoting transparency and exchange of information for tax purposes. A background information brief* (2010) OECD.

643 Organisation for Economic Co-operation and Development *Four more countries commit to OECD tax standards* (2009).

644 Organisation for Economic Co-operation and Development *G20 Leaders' statement: the Pittsburgh summit* (2009).

645 G8 "Responsible leadership for a sustainable future" <http://www.g7.utoronto.ca/summit/2009laquila/2009-declaration.pdf> (accessed 2020-05-27).

646 G8 "Responsible leadership for a sustainable future" <http://www.g7.utoronto.ca/summit/2009laquila/2009-declaration.pdf> (accessed 2020-05-27).

647 G20 "Declaration on strengthening the financial system <http://www.g20.org/Documents/Fin Deps Fin Reg Annex 020409 - 1615 final.pdf> (accessed 2020-05-27).

648 Organisation for Economic Co-operation and Development *Global forum on transparency and exchange of information for tax purposes* (2000).

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Besides the expansion of the GFT's leadership, the OECD also started with pilot projects consisting of multilateral negotiations to conclude bilateral agreements.[649] This method reduces transaction costs for both developing and developed countries.

However, the TJN has urged the GFT and OECD to explore more efficient options for fiscal transparency.[650] This stems from the flawed nature of bilateral agreements. If the OECD would rely on bilateral agreements to implement its standards, it may leave large opportunities to undermine the objective. Information exchange upon request agreements often lacks effectiveness because of the burdensome procedures to formulate a request and because some information in the requested jurisdiction is very hard to obtain altogether due to legal, regulatory and administrative obstructions.[651] This results in the information sought seldom being accessible.

3 9 3 Base Erosion and Profit Shifting

Following from the OECD's harmful tax practices project, the OECD and G20 countries identified the need for a comprehensive and cooperative international tax framework whereby all countries should work together to address and prevent tax avoidance. This laid the foundation for the emergence and development of the BEPS initiative.

The BEPS project seeks to close gaps in international taxation for corporations that allegedly avoid taxation or reduce their tax burden in their home country. This is typically achieved by engaging in tax inversions, moving operations or by migrating intangibles to lower tax jurisdictions. The OECD defines BEPS as "tax planning strategies that exploit gaps in the architecture of the international tax system to artificially shift profits to places where there is little or no economic activity or taxation".[652]

After two years of consultations and negotiations, the OECD launched the BEPS project. The initiative consists of a fifteen-point action plan, which aims to address the

[649] Organisation for Economic Co-operation and Development *Global forum on transparency and exchange of information for tax purposes* (2000).
[650] Tax Justice Network "Tax information exchange agreements" (2009) *Tax Information Exchange Arrangements Briefing Paper.*
[651] Tax Justice Network "Tax information exchange agreements" (2009) *Tax Information Exchange Arrangements Briefing Paper.*
[652] Organisation for Economic Co-operation and Development *BEPS 2015 Financial Reports* (2015).

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most prominent aspects of BEPS.[653] This includes but is not limited to topics regarding base erosion, profit shifting and the prevention of double non-taxation. In addition, the goal is to develop a universally accepted set of standards, which every country should eventually apply.[654] The objective is not only to address BEPS but hence to protect tax bases while offering increased certainty and predictability to taxpayers.

Currently, there are four minimum standards, which all BEPS participants must implement without exception.[655] These are actions 5, 6, 13 and 14. The minimum standards are also subject to a peer-review process to ensure timely and accurate compliance as well as a level playing field.[656]

In 2016, the OECD and G20 established an Inclusive Framework on BEPS to allow interested countries and jurisdictions to work with OECD and G20 members to develop standards on BEPS-related issues and review and monitor the implementation of the whole BEPS Package.[657] To date, 142 countries have joined the initiative.[658]

A detailed analysis and discussion of all fifteen actions fall outside the scope of this dissertation, but a short overview is provided below. For purposes of this study, action 5 is the most relevant.

3 9 3 1 Outline of the BEPS action plan

The BEPS project consists of the following actions: [659]

Action 1: Addressing the Tax Challenges of the Digital Economy

Action 2: Neutralising the Effects of Hybrid Mismatch Arrangements

Action 3: Designing Effective Controlled Foreign Company Rules

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653 Organisation for Economic Co-operation and Development *Action plan on base erosion and profit shifting* (2013)

654 Organisation for Economic Co-operation and Development *Action plan on base erosion and profit shifting* (2013)

655 Organisation for Economic Co-operation and Development *Action Plan on Base Erosion and Profit Shifting* (2013).

656 Organisation for Economic Co-operation and Development *OECD/G20 Inclusive framework on BEPS: progress report July 2019-July 2020* (2020).

657 OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).

658 Organisation for Economic Co-operation and Development *OECD/G20 Inclusive framework on BEPS: progress report July 2019-July 2020* (2020).

659 Organisation for Economic Co-operation and Development *OECD/G20 Inclusive framework on BEPS: progress report July 2019-July 2020* (2020).

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Action 4:	Limiting Base Erosion Involving Interest Deductions and Other Financial Payments
Action 5:	Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance
Action 6:	Preventing the Granting of Treaty Benefits in Inappropriate Circumstances
Action 7:	Preventing the Artificial Avoidance of Permanent Establishment Status
Actions 8–10:	Aligning Transfer Pricing Outcomes with Value Creation
Action 11:	Measuring and Monitoring BEPS
Action 12:	Mandatory Disclosure Rules
Action 13:	Guidance on Transfer Pricing Documentation and Country-by-Country Reporting
Action 14:	Making Dispute Resolution Mechanisms More Effective
Action 15:	Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

3 9 3 2 BEPS Action 5

It is undeniable that tax-dodging activities remain a risk to the global community. For this reason, action 5 of the BEPS project aims to continue the work and progress made by the harmful tax practices initiative. Because action 5 forms part of the BEPS minimum standards, a peer-review process is followed for all jurisdictions.[660] The renewed priority areas are centred around improving transparency, which includes compulsory spontaneous exchange on rulings related to preferential regimes and on requiring substantial activity for any preferential regime.[661]

The majority of concerns revolve around jurisdictions that can be used for artificial profit shifting and where a lack of transparency in connection with certain rulings threatens tax revenues.[662] One key focus of action 5 is to ensure that the

[660] Organisation for Economic Co-operation and Development *BEPS Action 5 on harmful tax practices: transparency framework* (2017).
[661] Organisation for Economic Co-operation and Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).
[662] Organisation for Economic Co-operation and Development *OECD/G20 Inclusive framework on BEPS: progress report July 2019-July 2020* (2020).

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substantial activity requirement is strengthened to realign the taxation of profits with the activities used to generate the revenue.[663] The report has identified the nexus approach as an appropriate criterion to assess whether there is substantial activity.[664] This method uses expenditures as a proxy for substantial activity. It thereby ensures that the taxpayer does not derive a benefit from the regime without undertaking the core income-generating activities.

A peer review aims to ensure the effective and consistent implementation of an agreed standard across all jurisdictions.[665] It also serves to recognise progress made by jurisdictions in this regard. The objective of the peer review is to evaluate the implementation of the standard against a collectively agreed set of benchmarks.[666] These criteria are contained in the terms of reference, which include each of the sub-elements that a jurisdiction needs to comply with.[667] Only once a jurisdiction can adequately demonstrate that it has fulfilled the aforementioned criteria is it accepted that effective implementation of the standard had been shown.

The following aspects are assessed during such peer-review process: [668]

1. the information gathering process;
2. the exchange of information;
3. statistics; and
4. confidentiality provisions.

With regards to improving transparency, a framework has been compiled and subsequently adopted.[669] It aims to regulate and facilitate the compulsory

[663] Organisation for Economic Co-operation and Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).
[664] Organisation for Economic Co-operation and Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).
[665] Organisation for Economic Co-operation and Development *OECD/G20 Inclusive framework on BEPS: progress report July 2019-July 2020* (2020).
[666] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).
[667] Organisation for Economic Co-operation *and* Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).
[668] Organisation for Economic Co-operation *and* Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).
[669] Organisation for Economic Co-operation *and* Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).

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spontaneous exchange of information on rulings that could give rise to BEPS concerns in the absence of such exchange.[670]

The framework covers the following categories: [671]

1. rulings related to preferential regimes;
2. cross-border unilateral advance pricing arrangements ("APA") or other unilateral transfer pricing rulings;
3. rulings giving a downward adjustment to profits;
4. permanent establishment rulings;
5. conduit rulings; and
6. any other type of ruling that, in the absence of exchange, would most likely give rise to BEPS concerns.

It should be observed that this does not automatically mean that such rulings are *per se* preferential in nature or that they will definitely give rise to a BEPS event,[672] but it does illustrate the potential that where there is a lack of transparency, there is a large probability that it may give rise to mismatches in tax treatment and instances of double non-taxation.[673] This is especially applicable to a jurisdiction's operations or administrative processes.

It is worthwhile to note that the above-mentioned transparency framework operates in conjunction with the other BEPS actions. Of the most noteworthy are the projects around the automatic exchange of information ("AEOI") and the CRS.[674]

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[670] OECD/G20 Base Erosion and Profit Shifting Project *Harmful Tax Practices – 2018 Progress Report Preferential Regimes* (2018).

[671] Organisation for Economic Co-operation and Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).

[672] Organisation for Economic Co-operation and Development *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2019-July 2020* (2020).

[673] Organisation for Economic Co-operation and Development *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency And Substance, Action 5 -2015 final report* (2015).

[674] Organisation for Economic Co-operation and Development *Standard for automatic exchange of financial information in tax matters* (2014). Organisation for Economic Co-operation and Development *Convention on mutual administrative assistance in tax matters* (2020). Organisation for Economic Co-operation and Development *Automatic exchange of information: what it is, how it works, benefits, what remains to be done* (2012). Organisation for Economic Co-operation and Development *Keeping it safe: The OECD guide on the protection of confidentiality of information exchanged for tax purposes* (2012). Organisation for Economic Co-operation and Development Report for the G8 Summit 2013 "A step in change in tax transparency". Organisation for Economic Co-operation and Development *Model mandatory disclosure rules for CRS avoidance arrangements and opaque offshore structures* (2019).

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A key aspect of the BEPS project hinges on mutual assistance in order to foster and strengthen co-operation and trust among participating countries. It is, therefore, paramount that the shared information is safeguarded and protected.[675] To this extent, the GFT has reviewed the confidentiality rules and practices, and has published a comprehensive toolkit. This will ensure that the automatic exchange of CRS information takes place in a secure environment. The findings of the GFT also applies to the peer-review process of the transparency framework.[676]

3 9 3 3 BEPS and the developing world

According to the African Tax Administration Forum ("ATAF"), the role of taxation in developing countries goes beyond just the fiscal component.[677] It plays a far bigger substantive role as well. Therefore, tax policy is shaped and influenced by economic and political institutions, interest groups and political culture.[678]

Due to the nature of developing countries, BEPS manifests and impacts differently in developing countries compared to the developed world.[679] This gave rise to the legitimacy of the BEPS action plan being questioned.[680] This is due to developing countries' limited participation in the decision making regarding the BEPS framework. There are concerns that the mismatch between the priorities of developing countries and that of the OECD may lead to key areas not being adequately addressed.[681] Furthermore, developing countries' perceptions and views of taxation differ from that of their developed counterparts.[682] The ATAF, therefore, stated that developing countries must come up with innovative ideas to solve the unique problems

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Organisation for Economic Co-operation and Development *International exchange framework for mandatory disclosure rules on CRS avoidance arrangements and opaque offshore structures* (2019).

[675] Organisation for Economic Co-operation and Development *Keeping it safe: The OECD guide on the protection of confidentiality of information exchanged for tax purposes* (2012).

[676] Organisation for Economic Co-operation and Development *OECD/G20 Inclusive framework on BEPS: progress report July 2019-July 2020* (2020).

Organisation for Economic Co-operation and Development Global *Forum Secretariat delivers new Confidentiality and Information Security Management Toolkit to assist in the implementation of the Automatic Exchange of Information Standard* (2020).

[677] African Tax Administration Forum *Cross boarder taxation: Implications for Africa* (2014).

[678] The Davis Tax Committee *Macro analysis of the tax system* 8.

[679] Oguttu AW "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *International Centre for Tax and Development Working Paper.*

[680] Burgers I "Corporate taxation and BEPS: A fair slice for developing countries" (2017) 10 *ELR.*

[681] 31.

[682] 32.

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faced by developing countries.[683] In addition, due to the limitations and challenges faced by revenue authorities in developing countries, the practicality of implementing BEPS is unclear.[684] According to the OECD, capacity building is a paramount prerequisite for developing countries to implement and apply the BEPS action plan successfully.[685] To this extent, organisations such as the OECD, IMF and G20 have launched various initiatives to aid in the preparation and upscaling of capacity at revenue authorities in developing countries. It is crucial to remember that even though these problems share a common result, the actions and methods required to prevent or curb such conduct differ significantly.

3 9 4 The Global Forum on Taxation

Originally the GFT consisted of OECD member countries, and other jurisdictions that had agreed to implement the recommended reforms.[686] Their primary purpose was to address the risks to tax compliance posed by non-cooperative jurisdictions.

The GFT evolved over the years and currently boasts over 160 members.[687] The structure is of such a nature, that all members are on equal footing.[688] In addition, the GFT is regarded as the premier international body for ensuring the implementation of the agreed standards for fiscal transparency.[689] Through an in-depth peer-review process, the GFT also monitors compliance among its members. It further works to establish a level playing field, even among countries that have not yet joined the GFT.[690]

683 African Tax Administration Forum *Cross boarder taxation* 16.
684 Oguttu AW "Tax base erosion and profit shifting in Africa – Part 1: Africa's response to the OECD BEPS action plan" (June 2016) *International Centre for Tax and Development Working Paper.*
685 Organisation for Economic Co-operation "Part 1 of a report to G20 development working group on the impact of BEPS in low income countries" (2014) *OECD* <http://www.oecd.org/tax/part-1-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf> (accessed 2 February 2023).
686 Organisation for Economic Co-operation and Development *Putting an end to offshore tax evasion* (2015).
687 Organisation for Economic Co-operation and Development *Putting an end to offshore tax evasion* (2015).
688 Sharman JC *Havens in a Storm* (2006) 149.
689 Organisation for Economic Co-operation and Development *Putting an end to offshore tax evasion* (2015).
690 Sharman JC *Havens in a Storm* (2006) 149.

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3 9 5 Criticism of the OECD

Aside from the critique already discussed, there is no shortage of criticism against the OECD and the harmful tax practices project. It should be observed that a full analysis and evaluation of the criticism falls outside the scope of this dissertation. However, a few important points are mentioned briefly.

The majority of the relevant critique revolves around the suitability or desirability of the OECD to spearhead the harmful tax practices project, the rationale behind the project and the way in which the OECD has handled participation and equitable treatment among countries.[691] In addition, the legitimacy of the OECD has also been questioned.[692]

There is a notion that the OECD's approach to tax havens is counterintuitive. The current regime revolves around identifying and punishing those jurisdictions that transgress. There is an argument to be made that by punishing tax havens, the OECD is actually exacerbating the problem.[693] This idea stems from the so-called "punishment paradox". It raises the question as to whether the OECD should not review the fundamental basis of their approach.

3 10 South Africa

South Africa is experiencing severe economic, political and social challenges. The high levels of capital outflows and tax avoidance exacerbate this. The reduced tax revenue and limited investments in the country greatly impair the state's ability to address these problems.

Based on the preceding discussion, the question arises as to whether South Africa should pursue an OFC strategy? Before the feasibility of the proposal can be evaluated, one must just touch on the reasoning and motivation behind such an approach.

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[691] Johnson RA "Why harmful tax practices will continue after developing nations pay: a critique of the OECD's initiatives against harmful tax competition" (2006) 26 *BCTWLJ* 352.
Ault HJ "Reflections and role of the OECD in developing international tax norms" (2009) 34(3) *BJoIL* 758.
Littlewood M "Tax competition: harmful to whom" (2004) 26 *MJoIL* 413.
Morriss AP "Cartelizing taxes: understanding the OECD's campaign against harmful tax competition" (2012) 4 *TA&MUSoL* 4.
[692] Fung S "The questionable legitimacy of the OECD/G20 BEPS project" (2017) 10 *ELR* 3.
[693] Singh "Tax havens: all you need to know" (19-07-2022) *Investopedia*.

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If South Africa decides to follow this road, the objective will be to mimic the success and growth strategy of Mauritius. Aside from the advantages and benefits of becoming a tax haven, this will help to diversify the South African economy and unlock new opportunities. Currently, the economy is largely centred on and reliant on primary commodities.[694] If successful, the development of the offshore financial services sector, will mean an additional avenue to attract much-needed FDI for the country.

If the criteria for becoming a tax haven is applied to South Africa, it is apparent that there are some aspects that will pose a challenge. Overall, South Africa complies with many of the characteristics commonly associated with tax havens, but some of the fundamentals are lacking.

Of all South Africa's shortcomings and obstacles to becoming a tax haven, the most noteworthy is the high tax rates, lack of economic openness and poor governance quality. As illustrated in the discussion in paragraph 3 4, governance quality is the most paramount requirement and most decisive indicator of successfully becoming a tax haven jurisdiction.[695]

South Africa is ranked the 106th freest country in the world, with an economic freedom score of 58.[696] In comparison with other peer countries such as Mauritius, South Africa trails far behind. This dismal performance is not only a substantial hindrance to economic growth but also to becoming a tax haven. Unfortunately, the same is true for South Africa's ratings on other leading indicators, such as the World Bank's GEDB ranking and the WEF's GCI.[697]

On the governance front, South Africa performs slightly better, but still nothing close to where it should be. South Africa ranks 7th in Africa on the IIAG index, with a score of 68.[698] Even though this is much higher than the average, it is still far from

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694 The World Bank "South Africa Economic Update – Jobs and Inequality" <http://pubdocs.worldbank.org/en/798731523331698204/South-Africa-Economic-Update-April-2018.pdf> (accessed 2020-07-06).

695 Dharampala D & Hines Jr JR "Which countries become tax havens?" (2009) 93 (9) *JoPE* 1060.

696 2020 Index of Economic Freedom "South Africa" https://www.heritage.org/index/country/southafrica#:~:text=South%20Africa's%20economic%20freedom%20score,freest%20in%20the%202020%20Index.&text=South%20Africa%20is%20ranked%2012th,slightly%20below%20the%20world%20average." (accessed 2020-07-06).

697 Schwab "The Global Competitiveness Report 2019" (2019) *World Economic Forum*.

698 African Governance Report "Agendas 2063 & 2030. Is Africa on track?"

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leading countries such as that of Mauritius. Other quality of governance indicators such as the TICPI and WGI, paints a similar picture for South Africa.[699]

In addition, other factors that may potentially have an impact on South Africa's ability to become a tax haven include the geographic size, the population size and the abundance of natural resources. None of the aforementioned elements have a positive correlation with tax haven status. However, independently these factors will not play a determining role, but may complicate the process.

Irrespective of the fact that becoming a tax haven has many appealing advantages and may even seem like the desirable route for South Africa, the feasibility of such an approach remains highly questionable. Before a tax haven strategy can be viable for South Africa, the country will have to address the core problems. At the very least, this will comprise reform measures to drastically improve the trajectory of the economic openness and governance quality ratings.

3 11 Conclusion

This chapter provided an overview of tax havens and focused the reader's attention on the most important facets. Due to the complexity and extent of the topic at hand, from the outset, it was never the objective to provide a detailed discussion on each aspect, but rather to introduce the subject and to highlight the essential parts, which will facilitate the comprehension of further chapters.

The topic of tax havens is, and remains, a very complex and controversial matter. Tax havens have received the blame for many of the key problems experienced in the world. Whether this is justified or not is still unclear, but it is evident that there is no simple answer. For this reason, any conclusion or pronouncement should be viewed within that specific context.

The development and emergence of tax havens, as they are known today occurred over many years and is still ongoing. Some are fighting for survival in the light of increased pressure and activity to curb or eradicate such operations. Others are innovating and adapting to new needs and ways of doing business.

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[699] Transparency International "Corruption Perceptions Index" <https://www.transparency.org/en/cpi/2019#> (2020-07-05). François R "Why should world governance be evaluated and for what purpose?" <https://www2.world-governance.org/IMG/pdf_WGI_full_version_EN.pdf> (accessed 07-05-2022).

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One has also witnessed the advent of different terminologies, classifications and naming conventions for tax havens. Despite all the developments in this field, there is still no uniformly accepted definition for a tax haven. Instead, the current definitions remain ambiguous in nature, with very slight or technical differences. This severely hampers the determination and classification process and subsequent policy reforms. It will therefore be beneficial for all stakeholders if consensus can be reached on the characteristics or criteria for what constitutes a tax haven jurisdiction. It is submitted that the lack of collaboration on this topic among academics and other organisations is problematic. More research and work are required in this regard.

In addition, this chapter has briefly touched on the question: why are there tax havens? At first glance, the answer may appear obvious. However, it quickly became clear that is not the case. Instead, pertinent questions have been raised. The notion that the international tax system is one of the biggest enablers and facilitators of tax havens goes against the general perception and long-standing beliefs regarding tax havens. Furthermore, the fact that tax havens are actually a side effect of the pursuit of capital neutrality by developed nations may possibly change or prompt a reconsideration of the core views on tax havens. It is submitted that this new line of thinking may also warrant a review of the policy stance towards tax havens and the measures adopted to combat such activities. A comprehensive proposal will only be possible after in-depth research have been performed on this matter. It will only be possible to evaluate the suitability and desirability of such an alternative approach at that stage.

Even though the benefits of becoming a tax haven are clear, not all countries have the potential to successfully become a tax haven. This stems from the notion that only countries that have specific attributes can become tax haven jurisdictions. This is regardless of their intention or desire to do so. Some of the most noteworthy characteristics include but are not limited to economic freedom and the country's quality of governance. It is submitted that countries that do not comply with the above-mentioned elements do not forego any advantage by not pursuing a tax haven agenda as their developmental strategy. Conversely, those countries who fulfil the criteria and wish to follow this route need to offer much more than mere low tax rates. In order to be competitive, countries should develop a comprehensive investment offering.

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From a consumer perspective, the advantages of using tax havens are as diverse as the different offerings available. In broad terms, the benefits typically revolve around lowering the cost of doing business or improving efficiency. On a more personal level, it generally entails circumventing unjust laws in the home country, such as forced heirship rules or expropriation without compensation policies.

Regardless of one's convictions on tax havens, the significance of tax havens in the global economy cannot be understated. It is estimated that more than one third of FDI and more than half of all banking assets are routed through these financial networks,[700] with accumulative wealth ranging somewhere between $7.8 trillion,[701] to a middling $10.3 trillion,[702] to as high as $21-32 trillion.[703]

Unfortunately, the existence of tax havens has numerous adverse consequences, which have a devastating effect on other countries. Among others, unfair tax competition, tax dodging and criminal activities are the most prominent. These activities also have the most detrimental impact on the global economy. Developing nations bear the brunt of such effects. It manifests in a loss of tax revenue and diminishes the country's tax base. In turn, this negatively affects service delivery and developmental projects.

Notwithstanding the aforementioned, there is also a positive side to tax havens. This aspect might be less well known but it is significant, nonetheless. Tax havens played a paramount role in reducing the burden on mobile capital. This, in turn, acts as a catalyst for cross-border investments and trade. In addition, it enabled the emergence of new business sectors which would otherwise not be commercially viable. Furthermore, the offshore financial industry offers developing countries a way to attract much-needed FDI, thereby giving countries the potential opportunity to avoid the Lucas paradox.

Aside from the above, there is also the assertion that the fear of the race to the bottom is entirely misplaced. There is further evidence that tax haven jurisdictions can

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[700] Palan, Murphy & Chavagneux *Tax Havens: How Globalization Really Works* 62.
[701] Zucman (2014) *JoEP* 121; G Zucman "The missing wealth of nations: Are Europe and the US net debtors or net creditors?" (2013) 128 *QJoE* 1321.
[702] Boston Consulting Group "Global Wealth 2017: Transforming the Client Experience" (13-06-2017) *Boston Consulting Group*.
[703] Tax Justice Network "New estimates for Missing Global Private Wealth, Income, Inequality and Lost taxes" <https://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf> (accessed 2020-04-04).

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positively affect high-tax countries in the surrounding area. It is also uncertain what would happen to those economies if they can no longer offer the financial and banking services they are so dependent on.

It is submitted that the influence of tax havens is not so apparent. This being said, it is evident that various problematic aspects of the current tax haven regimes need to be addressed. However, this does not mean that one cannot learn from and expand on the positive aspects.

The OECD and other organisations have made great strides in addressing harmful tax practices over the years. The OECD sought to better understand how tax havens affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the tax systems generally. The project's objective was to discourage the use of preferential tax regimes for investors and to encourage transparency, international co-operation and effective information exchange among the tax authorities of different countries.

The programme focused on identifying HPTRs and tax havens. To this extent, various lists were composed and subsequently published, all with the aim of pressuring those jurisdictions to implement reforms. Many countries did not take kindly to this process, with the OECD and the process being severely criticised.

Following from the OECD's harmful tax practices project, the OECD and G20 countries identified the need for a comprehensive and cooperative international tax framework to curb tax dodging. The BEPS project seeks to close gaps in international taxation for corporations that allegedly avoid taxation or reduce their tax burden in their home country.

The initiative consists of a fifteen-point action plan, which aims to address the most prominent aspects of BEPS.[704] This includes but is not limited to topics regarding base erosion, profit shifting and the prevention of double taxation. The project further contains four minimum standards, which all BEPS participants must implement. The minimum standards are also subject to a peer-review process.

Action 5 of the BEPS project aims to continue the work and progress made by the Harmful Tax Practices Initiative. The renewed priority areas are centred around

[704] Organisation for Economic Co-operation and Development *Action plan on base erosion and profit shifting* (2013)

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improving transparency and requiring substantial activity for any preferential regime.[705]

It is submitted that despite the progress and gains made to combat tax avoidance and related activities, there is still much to be done. There is further no shortage of critique against the OECD and the programme. The majority of critique revolves around the suitability or desirability of the OECD to spearhead the harmful tax practices project, the rationale behind the project and how the OECD has handled participation and equitable treatment among countries.[706]

There is a strong argument to be made for South Africa to become a tax haven, but whether this is a feasible and achievable approach is debatable. If successful, such a developmental policy will definitely assist the country in resolving some of the challenges it is currently experiencing. Despite the desirability of such a strategy, various problematic aspects will first need to be addressed.

If one applies the characteristics associated with tax havens to South Africa, it is apparent that not all the requirements are fulfilled. The most noteworthy being the economic openness and quality of governance. Other factors that may play a role include the geographic size, population size and the country's abundance of natural resources.

Notwithstanding the fact that South Africa contains attributes, which are not usually associated with tax haven jurisdictions, it is submitted that only the restrictive economic freedom and poor governance quality prevent South Africa from succeeding with this objective. The country should be cognisant of the negative consequences of tax havens and should try and limit such effects as much as possible.

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[705] Organisation for Economic Co-operation and Development *Countering harmful tax practices more effectively, taking into account transparency and substance, action 5 -2015 final report* (2015).

[706] Johnson RA "Why harmful tax practices will continue after developing nations pay: a critique of the OECD's initiatives against harmful tax competition" (2006) 26 *BCTWLJ* 352. Ault HJ "Reflections and role of the OECD in developing international tax norms" (2009) 34 *BJoIL* 758. Littlewood M "Tax competition: harmful to whom" (2004) 26 *MJoIL* 413. Morriss AP "Cartelizing taxes: understanding the OECD's campaign against harmful tax competition" (2012) 4 *TA&MUSoL* 4.

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CHAPTER 4: TAXATION OF TRUSTS

4 1 Introduction

This chapter aims to provide an accurate but concise overview of each jurisdiction's general tax laws as they pertain to trusts. However, it should not be construed as a detailed discussion of all facets but rather as an introduction to the subject and to lay the foundation for the chapters to follow. It should be emphasised that this chapter 4, which deals with the policy positions and general tax treatment of trusts, and chapter 5, which focuses on a discussion of the special anti-avoidance provisions, are interlinked and must be viewed as two parts of an overarching frame namely: the tax treatment of trusts. For this reason, the content must be read and understood in this context. Furthermore, each jurisdiction's general anti-avoidance rule ("GAAR") may be applied to transactions involving trusts. Whether the GAAR may be invoked is, in practice, a major consideration for all taxpayers, including the founder, trustees and beneficiaries of a trust. Consequently, a very brief overview of the GAAR in each jurisdiction is included in this chapter. Although space does not allow a detailed discussion of the GAAR, this dissertation would be lacking if the basic rules of and application of the GAAR to transactions involving trusts were not mentioned.

The chapter commences by discussing the different options available to countries when electing how trusts are treated for tax purposes and in whose hands the income is taxed. In broad terms, all deviations encountered ultimately originate from one or more of these categories. In addition, the goal is to discuss and highlight the main similarities and differences among the main jurisdictions. This serves as the background and foundation for the more advanced discussions in the following chapters. It is vitally important to have a fair understanding of the general rules regarding the taxation of trusts before focusing on the specific anti-avoidance provisions and subsequent recommendations. Moreover, reference is made to relevant tax rules and principles throughout the chapters that follow.

The stipulated objectives are attained by answering the following questions:

1. Do all jurisdictions tax trusts in the same way? Or what methods are available to countries to tax trusts?
2. How are trusts treated for tax purposes?
3. Are resident and non-resident trusts taxed in the same manner?

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4. How is a trust's residency status determined?
5. What is the conduit pipe principle, and how does it operate?
6. In whose hands are the trust's income taxed, and how is that determined?
7. What are the GAARs in each jurisdiction?

As with previous chapters, this chapter follows the comparative legal method. In order to promote and enhance consistency throughout the dissertation and, ultimately, the reading experience, the author has elected to discuss each jurisdiction in its totality before continuing to the next jurisdiction.

4 2 Approaches to trust taxation

According to Wheeler, income passing through the trust is taxed only once as a general rule.[1] However, the mechanisms used to achieve this objective differ significantly among countries.[2] It is worthwhile to note that there is currently no perfect system available. Each option has its positive and negative aspects. It will depend on the individual jurisdiction which option coincides the best with their domestic policies. Notwithstanding the former, this broad policy aim is widely adopted among common-law jurisdictions. In the context of the taxation of trusts, several different classifications have emerged, which are used to describe the systems applied for the taxation of trusts.[3] These classifications can be divided into three main categories. The first classification focuses on the mechanism used, while the second focuses on the person who is to be taxed within the trust relationship and the third classification focuses on the treatment of the trust entity as a whole.[4]

Under the first classification, the following options are identified:[5]

1. the initial choice system
2. the credit system
3. the deduction system

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[1] J Wheeler "The missing keystone of income tax treaties" (2011) 3 *WTJ* 247 247.
[2] 251.
[3] V Thuronyi & A Easson "Fiscal transparency" in V Thuronyi (ed) *Tax Law Design and Drafting* (1998) 1 8.
[4] M Brabazon *International Taxation of Trust Income: Principals, Planning and Design* (2019) 1 6.
[5] Wheeler (2011) *WTJ* 247 347.

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In the initial choice system, as the trust income is received, an election must be made on whether the beneficiary or the trust should be taxed.[6] For this reason, if a beneficiary is entitled to the trust income or if the income is distributed to the beneficiary within the tax year, that income is taxed in the hands of the beneficiary.[7] However, if no beneficiary is entitled to the income, the trust will be liable to tax on the income.[8] When the income is eventually distributed to the beneficiary, no tax is imposed on either the trust or the beneficiary. This is encountered where retained income is concerned.

The trustee and the beneficiaries are both taxed in terms of the credit system.[9] The trustee is taxed on the trust income, and the beneficiaries are taxed on the distributions. However, the beneficiaries are granted a credit for the tax paid by the trustee.[10] Moreover, in accordance with the deduction system, both the trust and beneficiaries are taxed as well, but in this case, the trust is allowed a deduction for the distribution made to the beneficiary.[11]

Based on the second classification, the focus shifts to the person being taxed.[12] This is in contrast to the first classification, where the mechanism in question was emphasised. In line with the aforementioned, trusts can be taxed on the grounds of: [13]

A. the settlor;

B. the trustee;

C. the beneficiaries.

In such cases, it is necessary to establish an adequate connection to the trust before it can be subjected to taxation.[14] Where any of the subcategories above are followed, this typically takes the form of residency.[15]

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[6] 347.
[7] 347.
[8] 347.
[9] Thuronyi & Easson "Fiscal transparency" in *Tax Law Design and Drafting* 27-28.
[10] Brabazon *International Taxation of Trust Income* 13.
[11] Wheeler (2011) *WTJ* 247 348.
[12] Thuronyi & Easson "Fiscal transparency" in *Tax Law Design and Drafting* 28.
[13] JW Hart "How various countries approach taxation of trusts" in M Cadesky & R Pease (eds) *Trusts and International Tax Treaties* (2006) 55.
[14] 55.
[15] Brabazon *International Taxation of Trust Income* 13.

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The rationale for jurisdictions that use the settlor's residency as the basis for imposing taxes upon the trust can be described as follows: There is the notion or perception that the settlor will retain substantial control over the trust assets and will not truly relinquish control to the trustees as is required under the trust structure.[16] This is especially relevant in circumstances where the settlor contributed the majority or a substantial part of the trust property. In addition, there is a strong argument to be made that the jurisdiction in which the settlor resides should have the economic basis for taxing the trust, particularly when the trust is established in a low-tax jurisdiction.[17] Under this system, the trust income is either attributed to the settlor personally, or the trustee is held liable to the tax on the trust income based on the settlor's residence.[18] One downside of this system, is that it may be unfair to tax a settlor on the entire trust income if the settlor's contribution to the trust fund only comprises a small portion of the accumulated value, with the bulk of the trust assets arising from other sources.[19] In such a case, in order to achieve an equitable and optimum result, it is not desirable to rely on this type of system in isolation.

For those jurisdictions that tax trusts based on the trustee's residence, the focus is placed on the legal owner of the trust property.[20] Depending on the jurisdiction, this can take the form of either the trustees or the trust. Alternatively, some jurisdictions tax trusts merely because the beneficiaries are residents of that jurisdiction.[21] In such a case, the residency of the beneficiaries is sufficient to constitute a causal link. Under this system, beneficiaries may be taxed either when they receive the trust income, or the income may be imputed to them, regardless of whether it was distributed or not.[22] Neither one of these options is without challenges. For example, if beneficiaries are only taxed when they receive trust income, trusts that are situated in low-tax jurisdictions will most probably accumulate the trust income for extended periods, delaying distributions to beneficiaries to an undetermined future date. As a result, this translates to substantial revenue losses for the taxing jurisdiction. However, the converse is also true, as this option has the advantage of offering relative simplicity.

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[16] Hart "How various countries approach taxation of trusts" in *Trusts and International Tax Treaties* 55.
[17] Wheeler (2011) *WTJ* 247 348.
[18] Hart "How various countries approach taxation of trusts" in *Trusts and International Tax Treaties* 55.
[19] Wheeler (2011) *WTJ* 247 348.
[20] Thuronyi & Easson "Fiscal transparency" in *Tax Law Design and Drafting* 26.
[21] Brabazon *International Taxation of Trust Income* 13.
[22] Wheeler (2011) *WTJ* 247 346.

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This method is suitable to use as a standalone system, so it avoids some of the complexities encountered when a combination of systems is used. Further simplifying this approach is the notion that only one party in the trust relationship is responsible for the tax due on the trust's income. In this case, the beneficiary is also the person who benefits from the trust. In addition, it is generally possible to ascertain the beneficiaries' residency status with relative certainty, which results in clarity and ultimately enhances compliance.

Under the third classification, the emphasis is placed on how each specific jurisdiction regards the trust structure for tax purposes. It is possible to distinguish between the following options:[23]

1. taxing the trust as a separate entity; and
2. taxing the trust as a hybrid flow-through system.

If the jurisdiction treats the trust as a separate entity, the trust income is only taxed in the hands of the trust.[24] Therefore, distributions to the beneficiaries are not relevant in determining the tax liability for the trust. The result of this system is that no tax is imposed when a distribution is made to a beneficiary because the income has already been subjected to tax in the trust's hands. Thuronyi and Easson argue that such a system can be unfair if the income is distributed to a beneficiary with a low tax rate.[25] The unfairness can be mitigated by granting the beneficiary a refundable credit for the taxes paid by the trust. It should be observed that there is a great overlap between the separate entity system, supplemented with crediting the beneficiary, and the credit system described under the first classification above.

If the jurisdiction applies the hybrid flow-through system, the beneficiaries are taxed on the income to which they have a claim in the particular tax year, while the trust is taxed on all remaining income.[26] The beneficiary's tax obligation arises from the income that is distributed to the beneficiaries or to which they are entitled. This means that the income does not necessarily have to be received by the beneficiary before the tax liability is imposed, but rather that such income must be allocated to the specific beneficiary. There is thus a noticeable similarity between the hybrid flow-

[23] Thuronyi & Easson "Fiscal transparency" in *Tax Law Design and Drafting* 26-27.
[24] Wheeler (2011) *WTJ* 247 249.
[25] Thuronyi & Easson "Fiscal transparency" in *Tax Law Design and Drafting* 27.
[26] 27.

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through system, the initial choice system and the deduction system, which was discussed under the first classification above.

According to Thuronyi and Easson, there is very little difference between the hybrid flow-through system and the separate entity system in which a refundable credit is granted.[27] Following this line of reasoning, an analogy between the hybrid flow-through system and the first classification's credit system must be recognised. Therefore, it can be derived that the third classification is similar to the first classification in many respects. Even though it uses slightly different methodologies, it still reaches comparable results. It is, therefore, unsurprising that many states adopt a combination of these systems, depending on the circumstances.

4 3 South Africa

4 3 1 General principles

As previously discussed,[28] the default position under South African law is that a trust is not a juristic person. For this reason, it does not have a separate legal personality and is instead an accumulation of rights and liabilities.[29] In certain instances, legislation regards a trust as if it is a juristic person.[30] This is done for operational and efficiency reasons but is only limited to the ambit of such an act. The Income Tax Act 58 of 1962 ("ITA") is such an example.
The ITA defines the term "trust" as:

> "any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person."[31]

[27] 10.
[28] See paragraph 2 2 2 above.
[29] E Cameron, T Honoré & MJ de Waal *Honoré's South African Law of Trusts* 6 ed (2018) 1 2.
[30] AP de Koker & RC Williams *Silke on South African Income Tax* (2021) para 12.18.
[31] Section 1 of the ITA.

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Once an entity is brought within the ambit of this definition, it will be regarded as a person for purposes of the ITA.[32] The result of granting such fictitious legal personality is that a trust is liable to tax in its own right and treated as such.[33]

Like all other taxpayers, trusts that are resident in South Africa are taxed, generally speaking, on their worldwide receipts and accruals, while trusts that are non-residents are taxed, generally speaking, only on income from South African sources.[34]

For the taxation of trusts, South Africa primarily applies an initial choice system and also views the trust structure as a hybrid flow-through entity. Under the second classification method, it uses a combination of systems depending on the specific circumstances. For example, some anti-avoidance provisions will ensure that certain income is taxed in the hands of the settlor, which is in line with option A[35]. In other cases, option B[36] is followed. This is demonstrated by subjecting resident trusts to taxation on all undistributed income. Furthermore, the trust's beneficiaries, who have a vested right to the income, will be liable to tax in their own hands. This scenario constitutes an example of option C[37].

In the case of an ownership trust, the trustees act as the trust's representative taxpayer.[38] In general, the trustees have a duty to represent the trust in all matters relating to taxation.[39] This typically includes filing returns for the trust estate, settling all the trust's tax liabilities and addressing all enquiries.

With the exception of special trusts and trusts that fall under a specific tax regime, all trusts are taxed at a flat rate equal to that of the highest marginal tax rate of individuals.[40] This currently stands at 45%.[41] There is no personal rebate available for trusts.[42] Similarly, a trust does not qualify for the exemptions offered to natural

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[32] Section 1 of the definition of "person".
[33] M Botha, R King, L van Vuuren & W van der Westhuizen *Estate Planning and Fiduciary Services Guide* 119.
[34] Section 1 of the ITA of the definition of "gross income".
[35] See paragraph 4.2 p 196.
[36] See paragraph 4.2 p 196.
[37] See paragraph 4.2 p 197.
[38] Section 153 of the Tax Administration Act 28 of 2011 ("TAA").
[39] M Honiball & L Olivier "Legal principles of South African trusts" in *The Taxation of Trusts in South Africa* (2011) 2 9.
[40] D Clegg & R Stretch "Chapter 8: Residence, source, CFC rules and foreign tax credits" in *Income Tax in South Africa* (2021) para 8.5.14.
[41] De Koker & Williams *Silke on South African Income Tax* para 12.21.
[42] Section 10 of the ITA.

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persons, such as the basic interest exemption.[43] However, trustees are permitted to claim deductions for which the trust qualifies, as set out in the ITA.[44]

Even though the trustee is the representative taxpayer of the trust, it is not necessarily the trustees that are assessed.[45] Depending on the circumstances, income derived from a trust can be assessed in the hands of the beneficiaries, the trust or the donor.[46] This is determined by virtue of section 25B and the deeming provisions in section 7 of the ITA.[47] In the instance that assessments are raised on beneficiaries or the donor, the normal income tax rates, as determined by the sliding scale for individuals, are applicable.[48] Beneficiaries that are resident in South Africa will be taxed on their worldwide receipts and accruals, while non-resident beneficiaries will be liable to tax only on their receipts and accruals from a South African source.[49] This means that a South African resident who is a beneficiary of a non-resident trust, may also be liable to tax on amounts distributed to it from the non-resident trust. Furthermore, a South African resident beneficiary may also be liable to tax on the distribution of a dividend from foreign shares owned by a South African resident trust.[50] It is important to remember that income will always only be taxed once. That is, either in the hands of the beneficiaries, donor or trust, but never both.[51] This illustrates that South Africa subscribes to the policy stance that trust income should only once be subjected to taxation throughout the trust relationship.

It should be observed that the trustees can, under certain circumstances, be held personally liable to taxes due in their capacity as the representative taxpayer for the trust. This provision will apply if the taxes remain unpaid while one of the following events occurs:[52]

1. in the instance where the trustee disposes or alienates any amount, in one form or another, in respect of which taxes are payable;[53] or

[43] Section 10.
[44] Botha et al *Estate Planning and Fiduciary Services Guide* 92.
[45] Clegg & Stretch *Income Tax in South Africa* para 28.2.4.
[46] Para 28.2.4.
[47] Honiball & Olivier *The Taxation of Trusts in South Africa* 23.
[48] De Koker & Williams *Silke on South African Income Tax* para 12.21.
[49] Section 1 of the ITA of the definition of “gross income”.
[50] De Koker & Williams *Silke on South African Income Tax* para 12.34.
[51] Para 12.21.
[52] Section 155 of the TAA.
[53] Section 155.

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2. in the case where the trustee disposes of funds, either in their possession or that are legally due to the trust if those funds could have been used legitimately to settle the tax obligations.

4 3 2 Determining residence status

Under South African tax law, the concept of residency is of the utmost importance. It is the criteria used to establish a person's tax obligations in the Republic.[54] South Africa uses a residency-based taxation system.[55] The result hereof is that South African residents are generally taxed on worldwide income while non-residents are usually only liable to tax on income derived from a source in the Republic.[56] Therefore one's residency status can have far-reaching consequences. The ITA distinguishes between natural and persons other than natural persons with regard to the test to be applied.[57] In the case of individuals, a person will be regarded as a resident for tax purposes if either the person complies with the "ordinarily resident test" or satisfy the "physical presence test".[58] The point of departure is to ascertain whether the individual is ordinarily resident.[59] Only if and when that fails would one continue with the physical presence test.

Where it concerns a person other than a natural person, the entity will be regarded as a South African tax resident if one of the following applies:

1. if incorporated, established or formed in South Africa;[60] or
2. if the place of effective management ("POEM") is in South Africa. [61]

It shall be recalled that the ITA regards a trust as a person for tax purposes.[62] Furthermore, the wording used in the ITA to describe the criteria for a person other than a natural person to be regarded as a South African resident is defined in such a way that it is all-encompassing. For this reason, even though trusts are not

[54] Section 1 para (I) of the ITA of the definition of "gross income".
[55] Section 1 para (i) of the definition of "gross income".
[56] Section 1 para (i) of the definition of "gross income".
[57] Section 1 para (2).
[58] Section 1 para (2).
[59] Paragraph (*a*)(i) of the definition of a "resident" in section 1(1).
[60] Paragraph (*a*)(i) of the definition of a "resident" in section 1(1).
[61] Paragraph (*a*)(i) of the definition of a "resident" in section 1(1).
[62] Section1 of the definition of "person".

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incorporated, this provision will still apply to trusts.[63] The phrase "established or formed" subsumes trusts. If interpretation rules are followed, the word "in" connotes a place within South Africa's borders. It has also been argued that instead of a geo-restriction meaning being followed, the word "in" should rather mean "under South African law".[64] If the purpose of a residency-based system is analysed, it is clear that both interpretations have merit. However, it is submitted that the former is preferable, especially if one considers the purpose of residency is to establish a clear link to the country. In addition, by having said link to the country, one is able to benefit from the nation's services, infrastructure and resources. In turn, this provides the justification for the said country to levy taxes on such persons. In light of the aforesaid, it is submitted that merely forming a trust in terms of South African law will not constitute a sufficient link for the purposes of determining its residency status. The type of connection required is of a physical nature, which is also aligned with the interpretation adopted in the residency tests for natural persons and the test for determining an entity's POEM in the case of persons other than natural persons. In the case of *inter vivos* trusts, the question one should turn to is when and where the contract was concluded and, in the case of testamentary trusts, when and where the will was validly executed to resolve the time and place of establishment or formation.[65] A discussion of these aspects falls outside the scope of this dissertation. However, the criteria of "established or formed" for residency is not very reliable because even though it can be objectively ascertainable where a trust was formed, the formation can easily be manipulated. Hence, the second criterion, namely the POEM, becomes important in determining residency.

The precise and exact meaning of the term POEM is troublesome, as is evident from the numerous cases on this subject.[66] As a point of departure, the courts have held that the inquiry into an entity's POEM depends on the case's specific facts and circumstances and should be treated as such.[67] The most authoritative view on this

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[63] I du Plessis "The residence of a trust for South African income tax purposes" (2009) 21 *SA Merc LJ* 329.
[64] 330.
[65] 334.
[66] B van der Merwe "Residence of a company – the meaning of 'effective management'" (2002) 14 *SA Merc LJ* 79.
[67] *Oceanic Trust Co Ltd NO v C:* SARS (2011) 74 SATC 127.

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matter was set out in the United Kingdom ("UK") case of *Smallwood*.[68] The court described the POEM as the place where key management and commercial decisions are in substance made. This ordinarily coincides with the place where top-level management exercises their powers. The court further held that the place of implementation or administration does not determine the POEM. Lastly, the court emphasised that an entity can only have one POEM at any one time.[69]

In the *Oceanic Trust* case, the court subsequently adopted the approach followed in *Smallwood*.[70] In the *Tradehold* case, the court confirmed the South African position that only top-level management should be used to determine POEM.[71] The latest South African Revenue Service ("SARS") interpretation note dealing with this matter is also aligned with the courts' stance.[72] This is a drastic departure from the position taken in previous iterations. Even though the interpretation notes are not legally binding on the courts and taxpayers, it gives immense insight about how SARS treats such cases in practice. SARS provides guidance in terms of the factors that should be taken into account. The following is especially underlined: [73]

1. where the head office is located;
2. decisions by shareholders are usually not relevant unless they usurp the role of management;
3. where meetings are held;
4. operational management decisions should be distinguished from top-level management;
5. if the authority of top-level management is partially or entirely delegated, the POEM would often be the place to which such delegation occurred;
6. the location of centralised support functions is typically separate from top-level management; therefore, it is of limited significance.

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[68] *Commissioner for Her Majesty's Revenue and Customs v Smallwood* [2010] EWCA Civ 778.
[69] *Commissioner for Her Majesty's Revenue and Customs v Smallwood* [2010] EWCA Civ 778.
[70] *Oceanic Trust Co Ltd NO v C:* SARS (2011) 74 SATC 127.
[71] *Commissioner for the South African Revenue Service v Tradehold Ltd* 2013 4 SA 184 (SCA).
[72] South African Revenue Service "Resident – Place of effective management" (03-11-2015) *SARS* <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-006%20-%20IN%206%20Issue%202%20place%20of%20effective%20management%20companies.pdf> (accessed 25-08-2020).
[73] South African Revenue Service "Resident – Place of effective management" (03-11-2015) *SARS*.

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It is worthwhile to note that the current South African interpretation of POEM is also the interpretation that the Organisation for Economic Co-operation and Development ("OECD") used to recommend prior to the 2017 amendment.[74] The uniformity brings much-needed clarification for taxpayers.

In summary, if a trust is formed in South Africa, the trust will be regarded as a South African resident. But, if a trust is not established in South Africa, one will have to determine the POEM of the trust in order to ascertain the trust's residency status. Although SARS initially followed a different approach, with the publication of the latest interpretation note, it is clear that SARS also views the POEM to be where key management and commercial decisions are in substance made. However, while researching the topic at hand, it became evident that the current method for determining a trust's residency status remains problematic. Instead of applying a general test for all persons other than natural persons, it is submitted that a more specific test is required for trusts. But what exactly that test should be is unknown. This question warrants further research and may be addressed by the author in subsequent projects. However, for now, the deliberation of the aforesaid question falls outside the ambit of this dissertation and is not discussed further.

4 3 3 The conduit pipe principle

One of the most fundamental principles of the taxation of the trust concept is the so-called conduit pipe principle.[75] This common-law phenomenon arguably enables the unmatched flexibility and versatility of the trust structure and distinguishes the way trusts function from other entity types.[76] In *Armstrong v CIR* ("*Armstrong*"),[77] the court held that income received by or accrued to a trust retains its nature until it reaches the ultimate beneficiary. Therefore, the tax liability is not just only deferred until the income is in the beneficiary's hands, but the income also retains its identity throughout this process. This means that the trust acts as a mere "conduit pipe" through which income

[74] OECD "Commentaries on the Articles of the Model Tax Convention" para 24.
[75] Honiball & Olivier *The Taxation of Trusts in South Africa* 74.
[76] Cameron, Honoré & De Waal *Honoré's South African Law of Trusts* 664.
[77] 1938 AD 343.

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flows.[78] This view was confirmed in *SIR v Rosen* ("*Rosen*"),[79] but the court added a qualification. The position was explained as follows:

> "the trust deed may itself entitle or oblige the trustee to administer the dividends in such a way that he is not a mere conduit-pipe for passing them on to the beneficiary, that in his hands their source as dividends can no longer be identified or they otherwise lose their character and identity as dividends, and that the beneficiary is thus entitled to receive mere trust income in contradistinction to the benefit of the dividend rights in terms of the above crucial phrase. Thus, a trust deed may endow the trustee with a discretion to pass on dividends to the beneficiary or to retain and accumulate them. If he decides on the latter, I think (but express no firm view) that the dividends might then lose their identity and character as dividends, so that, if they are subsequently paid out to the beneficiary, they might possibly no longer be dividends in his hands, for the conduit-pipe had turned itself off at the relevant time. But if he decides on the former, i.e., to pass the dividends on to the beneficiary, the condition suspending the beneficiary's entitlement thereto is fulfilled, and they would constitute dividends in his hands in the same way as if he had been originally entitled to them unconditionally under the trust deed, i.e., as if the conduit pipe had always been open."[80]

The above judgments can be reconciled as follows: In the case of a vesting trust, the beneficiary will be taxed on the income in accordance with the provisions of section 25B, but the income will still retain its identity.[81] Similarly, if the trustees of a discretionary trust exercise their discretion in favour of a beneficiary and subsequently resolve to make a distribution to such designated beneficiary, the income will be taxed in the hands of that beneficiary by virtue of section 25B, but the income will still retain its identity.[82] This means that the application of section 25B has no effect on the functioning of the conduit pipe principle. This position was recently confirmed in the

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[78] *Armstrong v Commissioner for Inland Revenue* 1938 AD 343; De Koker & Williams *Silke on South African Income Tax* para 12.16; DM Davis, C Beneke & RD Jooste *Estate Planning* (2016) para 6.2.
[79] 1971 1 SA 173 (A).
[80] *Secretary for Inland Revenue v Rosen* 1971 1 SA 172 (A) 190-191.
[81] De Koker & Williams *Silke on South African Income Tax* para 12.21.
[82] Honiball & Olivier *The Taxation of Trusts in South Africa* (2011) 74.

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CSARS vs The Thistle Trust[83] judgment, although the court held that the conduit pipe principle has no application based on the specific circumstances.[84]

Notwithstanding the aforementioned, the court also stated that it is possible that the conduit pipe can turn itself off. This will be the case where income is accumulated in the trust and only distributed to a beneficiary in a subsequent year of assessment.[85] Such income will lose its identity and be regarded as capital in the beneficiary's hands. Thus, if the trustee of a discretionary trust decides not to distribute any income to beneficiaries, the income will be taxed in the hands of the trustee and, when distributed to the beneficiaries in a subsequent year of assessment, will not be subject to income tax in their hands, but may well lose its character.[86] Therefore, in the case of the beneficiary who receives a distribution from the trust in a subsequent year, the income will not retain its nature, and the source of the amount paid to the beneficiary will no longer be the source of the original income but rather the trust itself.[87]

It should be observed that the statement in the *Rosen* case was *obiter*. Regardless, it is important to take note thereof, especially since it is a Supreme Court of Appeal case. In the subsequent case of *Estate Dempers v CIR* ("*Estate Dempers*"),[88] the court followed the reasoning in *Armstrong* and *Rosen* but without the qualification. There the court held that accumulated income that is capitalised and added to the trust fund could not alter its essential character as income rather than capital. However, it is doubtful that it was the court's intention to depart from the stance adopted in *Rosen.* It is considered that the *Estate Dempers* judgment must be read in the context of the facts of the case. The judgment revolved around the application of section 7(5) and not really the conduit pipe principle. If one views the remarks in isolation, one may be tempted to concur with the argument outlined above, but if viewed in the proper context, it is unlikely that the judge intended such an interpretation to be assigned to the statements made in the case. Especially considering that Trollip JA, who wrote the judgment in the *Rosen* case, also served on the bench in *Estate Dempers.*

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[83] (516/2021) [2022] ZASCA 153 para 24.
[84] *CSARS vs The Thistle Trust* (516/2021) [2022] ZASCA 153 para 25.
[85] *SIR v Rosen* 1971 1 SA 173 (A), 32 SATC 249.
[86] Davis, Beneke & Jooste "Chapter 6: The taxation of trust income" para 6.2.
[87] De Koker & Williams *Silke on South African Income Tax* para 12.21.
[88] 1977 3 SA 410 (A).

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A non-resident beneficiary will only be liable to tax on income derived from a South African source.[89] Since income retains its identity when it is distributed to a beneficiary with a vested right, the rules for determining the income's source will be applied to the specific portion of income, which is received and subsequently distributed to the beneficiary.[90]

Section 9 of the ITA contains specific scenarios in which the legislature outlines under what circumstances different types of income will be regarded as from a South African source.[91] The provision also contains a list of examples that will be regarded as from a source outside the Republic.[92]

The effect is that a South African trust that derives income from a source listed in the provision, such as dividends, interest or royalties, and that is subsequently (but in the same year of assessment) distributed to a non-resident beneficiary will be treated as income from a South African source if it is treated as such in terms of section 9. This means that such income will be subjected to tax in the non-resident's hands. The converse is also true. If the type of income falls within one of the categories that are regarded as from a source outside South Africa, no tax liability will arise. For example, if the beneficiary has a vested right to the dividend, it is deemed to have accrued to the beneficiary.[93] It retains its nature as a dividend and will, consequently, be from a South African source if paid by a resident company to a non-resident beneficiary. The interposition of the trust between the company and the beneficiary with a vested right is irrelevant for the purposes of determining the source of the dividend. Or put differently, the intervention of the trust between the payer of the income and the beneficiary will have no bearing on the outcome of the determination.

If the type of income is not listed in either of the subsections of the provision, it can be difficult to determine whether it is from a South African source or not. The courts' criteria and guidelines can help greatly in such a case. The leading case on this matter is *CIR v Lever Brothers & Unilever Ltd* ("*Lever Brothers*").[94]

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[89] Clegg & Stretch *Income Tax in South Africa* para 18.2.
[90] Honiball & Olivier *The Taxation of Trusts in South Africa* 79.
[91] Section 9(2) of the ITA.
[92] Section 9(4).
[93] Section 25B(1) and (2).
[94] 1946 AD 441.

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In the *Lever Brothers* case, the court held that one must first determine what gave rise to the income. In other words, what is the originating causal connection. Next, one must establish where the income is from. Or put differently, in what country or location is the income generated. Hence, the second part of the test refers to the geographical location. This means that only if the income in question complies with those requirements will it be regarded as from a South African source.

If it does happen that both South Africa and the resident country of the beneficiary regard the income as from a source within their country, it is possible that double taxation may occur.[95] This is because both countries will subject the income to tax. Fortunately, there are some measures to mitigate this problem. As a starting point, one can establish whether there is a double tax agreement in place between the two countries. Even though double tax agreements ("DTAs") do not usually solve a source-source conflict, it may still provide guidance. If such a DTA governs such a scenario, it will contain a provision outlining the process and extent of the relief available.[96] Otherwise, the resident country's domestic tax legislation should be consulted.[97]

4 3 4 The taxation of the trust parties

Section 25B of the ITA can be described as a deeming provision. It aims to regulate and determine which income, or part thereof, derived by a trust is taxable in the hands of which party.[98] This section also gives effect to and upholds the policy principle that trust income must only be subjected to tax once throughout the trust relationship. The provision is a codification of principles and practices developed by South African courts over time.[99]

It is important to be cognisant that section 25B functions subject to section 7 of the ITA. The provisions of section 7 are discussed in more detail in chapter 5, but its effect on the application of section 25 is crucial. If section 7 is applicable to the circumstances, the working thereof will take preference.[100] Section 25B, therefore, comes into operation only to the extent that section 7 does not already apply.[101]

[95] L Olivier & M Honiball *International Tax: A South African Perspective* 5 ed (2011) 300.
[96] 300.
[97] Section 6 *quat*.
[98] De Koker & Williams *Silke on South African Income Tax* para 12.21.
[99] Botha et al *Estate Planning and Fiduciary Services Guide* 92.
[100] Clegg & Stretch *Income Tax in South Africa* para 18.2.
[101] De Koker & Williams *Silke on South African Income Tax* para 12.21.

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However, it appears that not all authors concur with this interpretation. Davis *et al.* are of the view that the provisions of section 25B(2) are not subject to section 7.[102] As discussed below, section 25B(2) pertains to the exercise of the trustees' discretion. Nevertheless, the argument put forward is not convincing. It is submitted that the word "amount" in section 25B(2) should be read as a reference to the word "amount" in section 25B(1). In the latter case, based on the wording used, it is clear that the accrual of that amount is subject to the operation of section 7. Hence, by implication, section 25B(2) is also subject to the working of section 7.

Regardless of the outcome, the taxpayer has no prerogative to elect the applicable provision.[103] In certain cases, it would be more beneficial for the taxpayer if section 25B was to be applied. There can never be a scenario where a taxpayer is simultaneously subjected to both sections.

The relevant portion of Section 25B of the ITA reads as follows:

> "(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.[104]
>
> (2) Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary."[105]

The consequence of this provision is that the tax liability either lies with the trust or the beneficiaries, which are determined in accordance with this provision as follows:

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[102] D Davis, L Olivier, G Urquhart, R Engels-van Zyl & J Roeleveld *Juta's Commentary on Income Tax* (1999).

[103] RD Jooste "Offshore trusts and foreign income – the specific anti- avoidance provisions" (2002) *Acta Juridica* 186.

[104] Section 25B(1) of the ITA.

[105] Section 25B(2).

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1. An amount that is received by or accrues to a trust is deemed to have accrued to a beneficiary[106] if that beneficiary is ascertained, has a vested right to the income, and the amount has been derived for the benefit of that beneficiary. In such a case, the beneficiary is liable to tax on the relevant amount, and the trust has no tax obligation in respect of that amount.
2. An amount that is received by or accrues to a trust is taxed in the hands of the trust if there is no ascertained beneficiary for whose benefit the amount was derived, which has a vested right to that income. In such a case, only the trust will be taxed on that income and not the beneficiary.

If the trustees of a discretionary trust exercise their discretion in favour of a beneficiary during a particular year of assessment, the beneficiary will be regarded as having a vested right to that income and will consequently be subjected to tax on that income.[107] The effect of the former is that in such a case, the trust will not be liable to tax in respect of the income distributed to such a beneficiary.

It should be observed that only once the amount has vested in the hands of the beneficiary will the amount accrue to the beneficiary.[108] Or in other words, it is the action of vesting that results in the accrual to the beneficiary.

Thus, vesting can occur in two ways:[109]

1. in the case of a *vesting trust*, an amount is vested in a beneficiary based on and in accordance with the terms of the trust deed; or
2. in the case of a *discretionary trust*, the exercise of the trustee's discretion constitutes vesting in that beneficiary. This typically takes the form of adopting a resolution to distribute a specified amount to a specific beneficiary for that year of assessment.

It should be noted that the provision makes no distinction regarding the period of enjoyment.[110] This means that the only determining factor is whether vesting has

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[106] Section 1 of the definition of "beneficiary".
[107] Honiball & Olivier *The Taxation of Trusts in South Africa* 75.
[108] De Koker & Williams *Silke on South African Income Tax* paras 12.21 and 12.22.
[109] B van der Merwe "The meaning and relevance of the phrase vested right in income tax law" (2000) 12 *SA Merc LJ* 320.
[110] Botha et al *Estate Planning and Fiduciary Services Guide* 92.

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occurred or not. In the majority of cases, the time of vesting will closely coincide with the time that payment is made to the beneficiary, but this is not essential, and there are circumstances where this will not be the case. It may be that vesting has occurred, but enjoyment is postponed.[111] In such a case, the income will still be taxable in the beneficiary's hands from the time of vesting. Lastly, the benefit to the beneficiary can be either direct or indirect.[112] This means that the beneficiary is not required to receive the income personally before his tax liability arises. In the instance where an amount is vested in a beneficiary, but it is used for his upkeep, he will still be responsible for the taxation on that specific income.[113]

However, in the *CSARS vs The Thistle Trust*[114] judgment the court held that section 25B does not apply to a capital gain. The reference to 'amount' should be read to only refer to an amount of a taxable income nature and not also to include an amount of a capital gains nature.[115] Thus, 'any amount' will not include capital gains. Instead, the application of section 25B is limited to the taxation of income that accrues to a trust or its beneficiaries. In contrast, the Eighth Schedule is to be applied to the taxation of capital gains that accrue to trusts or their beneficiaries.[116]

In addition, the section also regulates who may claim the allowable deductions associated with the relevant trust income. This means that the deductions are allocated between the trust and the beneficiaries in the same proportion as the income received or accrued to the parties in terms of the provision.[117]

The effect of the above is that to the extent that the income is deemed to have accrued to a beneficiary, the beneficiary must claim the deduction, and to the extent to which the income is deemed to have accrued to the trust, the trust must claim the deduction.[118] However, the claimable deduction is subjected to a caveat. For a beneficiary, the allowed deduction is limited to the amount deemed to have accrued to the beneficiary from that trust during the year of assessment.[119] The trust may deduct any excess, but the same qualification still applies. Thus, for the trust, the

[111] Honiball & Olivier *The Taxation of Trusts in South Africa* 81.
[112] Clegg & Stretch *Income Tax in South Africa* para 28.
[113] De Koker & Williams *Silke on South African Income Tax* para 12.21.
[114] (516/2021) [2022] ZASCA 153.
[115] *CSARS vs The Thistle Trust* (516/2021) [2022] ZASCA 153 para 19.
[116] *CSARS vs The Thistle Trust* (516/2021) [2022] ZASCA 153 para 22.
[117] Para 12.21.
[118] Section 25B(3) of the ITA.
[119] Section 25B(4).

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deduction is limited to the taxable income of the trust in that year of assessment.[120] If there is any excess to this deduction, such portion constitutes a claimable deduction for the beneficiary during the immediately succeeding year of assessment against an amount accrued to him or her from the trust.[121]

As discussed above, the conduit pipe principle is embedded in section 25B. This principle enables the flow-through of income to the ultimate beneficiaries without losing the income's character. This means that the income retains its identity, even though it changed owners. This can be best illustrated by way of an example: Normally, if taxpayer A receives income from a mixture of dividends, interest and rentals and subsequently transfers money to taxpayer B, the income will be taxed in the hands of taxpayer A as well as in the hands of taxpayer B. Furthermore, the income's identity will be lost as soon as taxpayer A receives it. This means the classification or source of income is not transferable to taxpayer B. Therefore, the deductions or exemptions are not available for the benefit of taxpayer B. This is, however, not the case with trusts. In such instances, the income received by the trust keeps its identity on the condition that the income is awarded or distributed within the year of assessment. For example, the trust derives the following income: R100 from dividends, R100 from interest and R100 from rent. If a distribution is made to taxpayer A for the amount of R200, the income will still be treated as dividends and interest, respectively. The only amount that is taxable in the hands of the trust is the remaining R100.

However, there are exceptions to this rule. One such example is that of annuities.[122] If the trust derives income from various sources and is obligated or elects to pay an annuity to one or more of the beneficiaries, such payment will be treated as general income in the beneficiary's hands.[123] In other words, the income will lose its identity and its associated benefits. This means that although the payment will be classified as annuity income in the beneficiary's assessment, the income will not be afforded the special tax treatment of the underlying source but rather be taxed as ordinary income according to the taxpayer's applicable tax rate.

Section 25B further contains a provision that specifically focuses on cross-border arrangements. Section 25B (2A) of the ITA is a deeming provision that forms part of

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[120] Section 25B(5)(a).
[121] Section 25B(6).
[122] Clegg & Stretch *Income Tax in South Africa* para 28.
[123] De Koker & Williams *Silke on South African Income Tax* para 12.21.

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the ITA's wider measures to combat tax avoidance.[124] It is specifically aimed at the situation where a South African resident is a beneficiary of a non-resident trust.[125] Its objective is to regulate distributions from non-resident trusts and to combat income accumulation in such trusts. In such arrangements, the accumulated income is from a non-South African source and, therefore, not taxed in South Africa. If left unabated, the subsequent distribution by the trust will constitute a capital distribution, thus avoiding the payment of income tax in South Africa.[126] As with section 7, the working of section 25B (2A) is discussed in chapter 5 in more detail.

Sometimes, it is also possible that income derived by the trust is not taxable in the hands of the trust, nor in the hands of the beneficiaries, but rather in the hands of another party.[127] This will typically take the form of the settlor or donor. In such a case, the working of section 7 of the ITA will be applicable.

Even though section 7 and its accompanied subsections are often analysed or discussed in the context of South African residents, their application is not limited to residents alone.[128] It is clear from the manner in which the provisions are phrased that their scope extends to non-residents as well. In addition, subsection 8 is specifically aimed at non-residents.

4 3 5 The South African GAAR

In light of the fact that trusts are often used for tax planning or structuring commercial transactions or schemes, it is necessary to consider the GAAR as contained in the ITA.[129] Despite the GAAR's practical relevance and its important role in counteracting tax avoidance arrangements, the discussion on the GAAR will be limited to a mere overview. Thus, a comprehensive analysis of the GAAR falls outside the ambit of this dissertation, but an overview is included for completeness' sake and to emphasise that the operation of the GAAR must always be considered.

The South African GAAR was originally contained in section 103(1) of the ITA but was since recalled and replaced with sections 80A to 80L.[130] However, the case

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[124] Davis, Beneke & Jooste *Estate Planning para 6.3.*
[125] Para 6.2.
[126] Jooste (2002) *Acta Juridica* 201; Davis *et al Estate Planning* para 6.3.1.
[127] Honiball & Olivier *The Taxation of Trusts in South Africa* 69.
[128] Olivier & Honiball *International Tax: A South African Perspective* 303.
[129] Cameron, Honoré & De Waal *Honoré's South African Law of Trusts* 361.
[130] De Koker & Williams *Silke on South African Income Tax* para 24.155.

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law on section 103(1) may be of some benefit in interpreting the new provisions. But, for purposes of this dissertation, section 103(1) will not be discussed.

The provisions which have replaced section 103(1) centre on the concept of "impermissible tax avoidance schemes". Section 80A defines the term "impermissible avoidance arrangement" by listing the requirements which must be met. The requirements are largely similar to those contained under the previous GAAR.[131]

However, it is important to note that there must be a coupling of the "sole or main purpose" to obtain "a tax benefit" with one of the "tainting" elements depending on whether the arrangement is in the context of businesses or other than in the context of business for an arrangement to be classified as an impermissible avoidance arrangement.

The powers that the Commissioner has concerning an impermissible avoidance arrangement are set out in section 80B. Furthermore, the provisions of section 80C to 80G expand on the requirements listed in section 80A. While section 80H to 80K contains general provisions and describes certain procedural issues that may arise.

Section 80L defines the terms "arrangement", "avoidance arrangement", "impermissible avoidance arrangement", "party", and "tax". However, the term "tax benefit" is defined in section 1 and not in section 80L.

Before the provisions in section 80A to 80L can apply, four requirements must be complied with. These requirements can be summarised as follows:[132]

1. There must be an arrangement.
2. The arrangement must result in a tax benefit and constitute an avoidance arrangement.
3. The sole or main purpose of the avoidance arrangement is to obtain a tax benefit.
4. If the avoidance arrangement is in the context of business, one of four elements must be present, namely:
   a. means or manner not normally employed;
   b. rights or obligations not normally created;
   c. lack of commercial substance; and
   d. misuse or abuse of provisions of the Act.

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[131] Honiball & Olivier *The Taxation of Trusts in South Africa* 87.
[132] Section 80A of the ITA.

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Alternatively, if the avoidance arrangement is in a context other than business, one of the following three requirements must be met:

a. means or manner not normally employed;
b. rights or obligations not normally created; and
c. misuse or abuse of provisions of the Act.

The Explanatory Memorandum makes it clear that these provisions are intended to act as a deterrent to taxpayers contemplating entering into impermissible tax avoidance arrangements.[133]

Unlike under the old section 103(1), the new provisions in sections 80A-80L can be applied to any part of or step in an arrangement, even if the arrangement overall has a commercial purpose.[134] In addition, it is expressly provided in section 80 that the statutory anti-avoidance provisions may be used in the alternative to any other basis for the assessment. This removes the doubts expressed by the courts under section 103(1), the Commissioner had to be satisfied with the requirements provided for in the section. He could not be so satisfied if the section was only argued in the alternative.[135]

Thus, first, there must be an arrangement. According to section 80L, an arrangement is widely defined as any transaction, operation, scheme, agreement or understanding. For purposes of said definition, it is irrelevant whether the aforesaid are enforceable or not.[136] Moreover, in terms of section 80H, the Commissioner may apply the provisions of Part IIA to the steps or parts of an arrangement.

The words "transaction, operation or scheme" were also contained in the previous GAAR.[137] In the case of *Meyerowitz v CIR*,[138] which dealt with section 103(1), it was held that the term "scheme" is wide enough to cover a series of transactions and to cover situations in which later steps in the course of action were left unresolved at the outset. However, the terms "agreement" and "understanding" are new

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[133] National Treasury "Explanatory Memorandum on the Revenue Laws Amendment Bill, 2016" (2016) *SARS* <https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-2006-01-Explanatory-Memorandum-Revenue-Laws-Amendment-Bill-2006.pdf > (accessed 05-12-2022).
[134] Section 80H of the ITA.
[135] ITC 1625 59 SATC 383 395
[136] Davis, Beneke & Jooste *Estate Planning* para 2.3.2.2.
[137] D Clegg & R Stretch "Chapter 26: Tax avoidance and reportable arrangements" in *Income Tax in South Africa* (2021) para 26.32.
[138] 25 SATC 287.

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components, and the courts must still determine the meaning and scope of these terms.

According to the SARS Draft Comprehensive Guide to the General Anti-Avoidance Rule, these terms include any form of side letter, moral obligation under the so-called gentlemen's agreement, and letters of wishes.[139] Following this line of reasoning, it should further be interpreted to include verbal, written and tacit agreements or understandings.

Due to the inclusion of the words "whether enforceable or not", it is considered irrelevant whether an agreement is a formal written document or simply creates a verbal understanding of any proposed future acts. Regardless of the form adopted, it could still constitute an arrangement.

It is submitted that the effect of section 80H is that SARS could potentially invoke the GAAR on a step of an "arrangement" that seems driven by a tax benefit, irrespective of it being essential to the agreement as a whole, which lacks a main tax avoidance purpose. According to Clegg, the question should be whether the particular step is commercially necessary for achieving the intended final commercial result or whether it could be dispensed with without affecting the commercial end result.[140]

Second, the arrangement must be an avoidance arrangement. This is defined to mean any arrangement that, but for the provisions of Part IIA, results in a tax benefit.[141] A tax benefit is defined to include any avoidance, postponement or reduction of any tax liability,[142] while tax is defined to include any tax, levy or duty imposed by the ITA or any other Act administered by the commissioner.[143] It is submitted that a tax benefit bears the same meaning as was ascribed to the concept of a transaction having the effect of avoiding tax in section 103(1) of the ITA before the repeal of that section, which can be described as getting out of the way of, escaping or preventing an anticipated liability for tax.[144]

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[139] South African Revenue Service "Tax Avoidance" (2006) *SARS* 15 <https://www.sars.gov.za/wp-content/uploads/Legal/RespDocs/LAPD-LPrep-Resp-2006-03-Response-Document-Revised-Proposal-Tax-Avoidance-section-103.pdf> (accessed 05-12-2022).
[140] Clegg & Stretch *Income Tax in South Africa* para 26.32.
[141] Section 80L of the ITA.
[142] Section 1 of the definition of tax benefit.
[143] Section 80L.
[144] *Smith v CIR* 1964 1 SA 324 (A).

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Although the ITA does not provide a test to determine the existence of a tax benefit,[145] it was held by the court in *Copthorne Holdings Ltd v Canada*[146] that the existence of a tax benefit could be established by a comparison of the taxpayer's situation with an alternative arrangement. If a comparison approach is used, the alternative arrangement must be the one that "might reasonably" have been carried out but for the existence of the tax benefit. The "but for" test simply asks whether, but for the existence of an arrangement, would tax have been suffered.

The third requirement requires that the purpose of the avoidance arrangement must be ascertained.[147] Section 80G(1) determines that the purpose of the avoidance arrangement should be reasonably considered in light of the relevant facts and circumstances.

According to section 80G, it is presumed that an avoidance arrangement has been entered into or carried out with the sole purpose of obtaining a tax benefit. This will be presumed unless and until the party obtaining the tax benefit proves that, reasonably considered in light of the relevant facts and circumstances, obtaining a tax benefit was not the sole or main purpose of the avoidance arrangement. This presumption places the onus of proof on the taxpayer, and the taxpayer must therefore prove that he had another sole or main purpose in entering said arrangement.

However, a mere assertion by the taxpayer will not be sufficient to discharge the onus. Instead, the facts and circumstances must objectively collaborate the claims.

It is submitted that, as was held in relation to the similar requirement under the previous section 103(1), the test of purpose is a subjective one, which takes as its criterion the purpose that those carrying out the scheme intend to achieve by means of the scheme. However, this aspect is very controversial, and a number of authors believe that the purpose test was intended to be an objective determination.[148] Notwithstanding, the purpose of achieving a non-tax objective through an arrangement in the most tax-efficient manner does not necessarily mean that the sole or main purpose of the arrangement is to avoid tax.[149] In this regard, it has been held that a

[145] Davis, Beneke & Jooste *Estate Planning* para 6.2.
[146] 2011 SCC 63.
[147] Section 80A of the ITA.
[148] De Koker & Williams *Silke on South African Income Tax* para 19.38.
[149] Davis, Beneke & Jooste *Estate Planning* para 2.3.2.2.

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taxpayer is entitled to structure its affairs to minimise its tax liability, provided it does not do so for the sole or main purpose of avoiding tax.[150]

For the fourth requirement, one must first determine whether the avoidance arrangement is in the context of business or not.[151] Depending on the classification, the requirements that need to be met will differ. For such determination, consideration should be given to the taxpayer's intention, the profit and the frequency of such act, including the requirement for a series of actions to obtain the income.[152] But, there is no overriding presumption regarding abnormal means or manner, rights or obligations or the misuse or abuse of provisions of the Act. It is therefore submitted that the Commissioner must show, on a balance of probabilities, that abnormality exists or that there was misuse or abuse.

In order to satisfy the fourth requirement, it is sufficient if only one of the sub-requirements of the context concerned is met.[153] Thus, the arrangement concerned must have one of the following tainting elements:[154] (3)

A. means or manner not normally employed;

B. rights or obligations not normally created;

C. misuse or abuse of provisions of the Act; or

D. lack of commercial substance.

A. Means or manner not normally employed

This requirement is met if the means or manner it was entered into or carried out would not normally be employed for *bona fide* purposes other than for obtaining a tax benefit. Such determination entails comparing the taxpayer's transaction and how a similar transaction would normally be carried out.[155] The test does not require an arrangement to have a business purpose. It merely requires that the method and manner by which the transaction was entered into should be normal in a business context.

B. Rights or obligations not normally created

[150] *CIR v Louw* 1983 3 SA 551 (A), 45 SATC 113.
[151] Section 80A of the ITA.
[152] De Koker & Williams *Silke on South African Income Tax* para 19.38.
[153] Honiball & Olivier *The Taxation of Trusts in South Africa* 88-89.
[154] Clegg & Stretch *Income Tax in South Africa* para 26.32.
[155] Davis, Beneke & Jooste *Estate Planning* para 2.3.2.2.

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This sub-requirement is met if the rights or obligations created would not normally be contracted or created between persons dealing at arm's length.[156] The test for whether an avoidance arrangement has created rights and obligations not normally created between parties dealing at arm's length is a factual inquiry considered against the hypothetical normal transaction.[157] Thus, it must be objectively ascertained.

C. Misuse or abuse of provisions of the Act

This provision attempts to ensure that the purpose of the legislation and the provisions of section 80A to 80L are taken into account.[158] In short, this requirement merely confirms the requirements of the rules of interpretation and the Constitution of the Republic of South Africa, 1996 ("Constitution"), namely that the contextual and purposive approach must be followed in the interpretation of legislation.[159] The misuse or abuse requirement apparently developed from the Canadian GAARs.[160] A Canadian court case that might provide guidance is *Canada Trustco Mortgage Co v Canada.*[161] The court indicated a two-stage process, namely:

1. Interpret the provisions relied on by the taxpayer, giving rise to the tax benefit to determine the provisions' object, spirit and purpose.
2. Determine whether the transaction frustrates or defeats the object, spirit or purpose of the provisions. It was argued that this process will lead to a finding of "abusive tax avoidance" (comparable to our "impermissible tax avoidance") if: [162]
    a. a taxpayer relies on specific provisions in order to achieve an outcome that those provisions seek to prevent, or
    b. a transaction defeats the underlying rationale of the provisions that are relied upon, or

[156] Section 80A(c)(i) of the ITA.
[157] Honiball & Olivier *The Taxation of Trusts in South Africa* 90.
[158] Section 80A(a)(ii) of the ITA.
[159] Clegg & Stretch *Income Tax in South Africa* para 28.32; J Cassidy "Tainted elements or nugatory directive? The role of the general anti-avoidance provisions ("GAAR") in fiscal interpretation" (2012) 23 *Stell LR* 319 326.
[160] BJ Kujinga "Analysis of misuse and abuse in terms of the South African general anti-avoidance rule: lessons from Canada" (2012) 45 *CILSA* 42-63.
[161] 2005 SSC 54.
[162] LA Steenkamp, J Roelveld & C West "Tapping into a quarter-century's judicial experience with the Canadian General Anti-avoidance Rule (GAAR): some insights for South Africa" (2016) 49 *CILSA* 477-505.

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c. an arrangement circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions.

D. A lack of commercial substance

Section 80C(1) provides a general rule (or rather a presumptive test) for determining whether an avoidance arrangement lacks commercial substance. Section 80C(2) contains a non-comprehensive set of characteristics that serve as indicators of a lack of commercial substance.

In terms of section 80C(1), the general rule or presumption is that an avoidance arrangement lacks commercial substance if it results in a significant tax benefit for a party, but the avoidance arrangement does not have a significant effect upon either the business risks or the net cash flow of that party. Since the word "significant" is not defined, this presumption is problematic. Thus, the benefit must presumably be significant in the context of the taxpayer's financial affairs in general.[163] However, it is equally difficult to determine what will constitute a "significant effect".

It is submitted that it is unclear what perspective the court will adopt in determining the significance of the tax benefit. It can either be viewed subjectively, which means from the viewpoint of the specific taxpayer. But it can also be assessed objectively, which means from the viewpoint of a reasonable person. It is further submitted that the objective view is more appropriate. However, the specific circumstances of each arrangement will have to be taken into account since "significant" will differ from person to person. If it is established that a "significant" tax benefit has been obtained, it could also indicate that it was the main purpose of the arrangement.[164]

According to section 80C(2), possible indicators of a lack of commercial substance may include but are not limited to the below:

1. legal substance or effect of the avoidance arrangement as a whole differs significantly from the legal form of its individual steps;
2. round-trip financing, as described in section 80D, is present;
3. an accommodating or tax-indifferent party, as described in section 80E, is

[163] De Koker & Williams *Silke on South African Income Tax* para 24.177.
[164] Davis, Beneke & Jooste *Estate Planning* para 2.3.2.2.

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included or present;

4. the inclusion or presence of any elements that have the effect of offsetting or cancelling each other.

However, a discussion of the above-mentioned elements and the accompanying provisions falls outside the ambit of this dissertation and will not be further discussed.

It may be argued that the so-called “tainted element” or “abnormality requirement” is so widely defined that it would be very difficult for a taxpayer to argue that this requirement has not been satisfied. However, all four requirements must be present before SARS can apply the GAAR.

Once all the section 80A requirements for an arrangement to constitute an impermissible avoidance arrangement are present, section 80B empowers the Commissioner to take certain action:

1. Section 80B(1)(f) provides a general remedy to the commissioner. In terms of this provision, the tax consequences under the Act may be determined as if the transaction had not been entered into or carried out. In the alternative, it must be determined in such other manner as in the circumstances of the case as the Commissioner deems appropriate for the prevention or diminution of the specific tax benefit derived. The words “determine the tax consequences under the Act” entail that the Commissioner may only determine or adjust taxes levied by the ITA when an arrangement is found to be an impermissible avoidance arrangement.
2. The Commissioner is also provided with specific remedies to impermissible tax avoidance arrangements as contained in section 80B(1)(a)-(e). These specific remedies allow the Commissioner, amongst others, to:
    a. disregard or combine any steps in or parts of the arrangement;
    b. disregard any accommodating or tax-indifferent party or deem the party and any other party as one and the same person;
    c. deem connected persons to the impermissible avoidance arrangement as one and the same person; or
    d. to re-allocate or reclassify any gross income, receipts or accruals of a capital nature, expenditure or rebates.

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According to Section 80B(2), the Commissioner must make the necessary and appropriate adjustments to the applicable tax liabilities to ensure the consistent treatment of all the parties to the arrangement.

Section 80F allows the Commissioner to combine connected persons and disregard an accommodating or tax-indifferent party or to combine it with another party to determine:

1. whether an avoidance arrangement lacks commercial substance: or
2. whether a tax benefit exists.

4 4 United Kingdom

4 4 1 General principles

As discussed previously,[165] unlike some other entities, a trust does not constitute a juristic person under UK law.[166] Neither does a trust have a separate legal existence, but rather acts through the trustees. Therefore, a trust can be described as an arrangement recognised by law under which one person holds property for the benefit of another.[167] This notion of the separation between control and enjoyment forms the essence of the trust structure.

Generally speaking, a trust is regarded as a separate taxable entity distinct from the settlor and the beneficiaries.[168] Notwithstanding the aforesaid, a trust cannot act without the trustees' assistance. Thus, it is not the trust itself that takes any action but the body of trustees that serves as a proxy for the specific trust.

According to the Income Tax Act of 2007 ("ITA7"), for tax purposes, the trustees of a settlement are together treated as if they were a single person, distinct from the persons who may, from time to time, in fact be trustees of said trust. This means that the statute grants the collective board of trustees a fictitious legal personality in their official capacity as trustees. This notional persona subsumes all the trustees, regardless of the actual number, and is subsequently treated as a singular entity within the tax context. This so-called trustee is tasked with ensuring that the trust's tax affairs are up to date and in order.

[165] See paragraph 2 3 2 above.
[166] DJ Hayton *The Law of Trusts: Fundamental Principles of Law* (1989) 134.
[167] A Hudson *Equity and Trusts* 9 ed (2017) 43.
[168] E Chamberlain & C Whitehouse *Trust Taxation* 4 ed (2014) 8.

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Unlike most other countries, the UK uses both a person's residency status and domicile as determinants for levying taxes.[169] The combination of the aforementioned factors influences one's tax liability. As is generally the case with most individual taxpayers, trusts that are resident in the UK are typically taxed on their worldwide receipts and accruals, while non-UK resident trusts are normally not subject to UK taxation on any foreign receipts and accruals but are only liable to UK taxation on UK source income.[170] However, the tax treatment of corporations is slightly different.

In recent years the corporate basis for taxation has gradually shifted from a worldwide system to a broad territorial system.[171] This forms part of the UK's efforts to modernise the tax regime and create an overall competitive business environment.

For the taxation of trusts, the UK mainly uses the credit system and also views the trust structure as a hybrid flow-through entity.[172] Under the second classification method, it applies a combination of approaches depending on the specific circumstances. To illustrate, all income received by settlor-interested trusts is taxed in the hands of the settlor. Similarly, some anti-avoidance rules ensure that the settlor is subjected to tax for certain income, even if the settlor does not receive it. Both the preceding examples are in line with option A[173]. Under other conditions, option B[174] is followed. One prime example of the aforesaid is where undistributed or accumulated income is taxed in the hands of the trustees. In addition, it is possible for trustees of a fixed trust to mandate income to a beneficiary. In such a case, not only is it the beneficiary who receives said income, but it is also legally entitled to it and, consequently, taxed accordingly. The latter scenario is an example of option C[175].

As was alluded to above, in most cases, the trustees are responsible for the administration of the trust and the tax affairs.[176] If there is more than one trustee, it is prudent to nominate a specific trustee to take the lead. This does, however, not release the fellow trustees from their duties nor any adverse consequences that may follow for failing to comply with the legislative requirements. Under certain conditions, the

[169] J Booth *Booth and Schwarz: Residence, Domicile and UK Taxation* 20 ed (2018) 9.
[170] J Kessler *Taxation of Non-Residents and Foreign Domiciliaries* 18 ed (2020) paras 20.17 and 20.18.
[171] Chamberlain & Whitehouse *Trust Taxation* 17.
[172] Wheeler (2011) *WTJ* 247 347.
[173] See paragraph 4.2 p 196.
[174] See paragraph 4.2 p 196.
[175] See paragraph 4.2 p 197.
[176] I Maston *Tolley's UK Taxation of Trusts 2018-19* 28 ed (2019) para 5.4.

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trustees can be held personally liable for the trust's tax obligations.[177] In general, the trustees have a duty to represent the trust in all matters relating to taxation. This often includes filing returns for the trust estate, settling all the trust's tax liabilities, updating the trust registry, compiling and distributing statements and addressing all enquiries.[178]

Under UK law, there are different rules and applicable tax rates for different types of trusts and different types of income.[179] Trustees of settlor-interested trusts are taxed the same as the trustees of any other trust. The applicable tax rates depend on what type of trust the settlor-interested trust is.

For discretionary trusts, income up to £1000 is taxed as follows: [180]

Dividend income:	7.5%
All other income:	20%

For income over the £1000 threshold, the tax rates are as follows: [181]

Dividend income:	38.1%
All other income:	45%

In the case of a fixed or an interest in possession trust, there is no distinction between a basic and higher band.[182] In other words, there is a flat rate for each type of income, regardless of the amount received. However, it should be noted that income will also be assessed on the beneficiary. An extra tax liability can arise if the beneficiary is liable to tax in accordance with the higher rate band or the additional rate band.

For the trust, the following tax rates are applicable:[183]

Dividend income:	7.5%
All other income:	20%

[177] Chamberlain & Whitehouse *Trust Taxation* 12.
[178] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 104.51.
[179] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.1.
[180] Para 6.4-6.6.
[181] Para 6.4-6.6.
[182] Chamberlain & Whitehouse *Trust Taxation* 12.
[183] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.9.

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Bare trusts are subjected to tax at the same tax rates as applicable to individual taxpayers.[184] The different treatment can be explained by the notion that the income is taxed in the hands of the beneficiaries instead of the trustees. In such a case, a progressive sliding scale is used based on the level of income received. The current tax bands range from 20% to 45%.[185]

In addition, tax legislation makes provision for special tax treatment for certain types of trusts, which are formed to support certain designated groups of persons. These so-called trusts for vulnerable beneficiaries are eligible to receive substantial tax relief if they meet the strict criteria and fulfil all the requirements.[186]

Furthermore, there is no personal rebate available for trusts.[187] Neither does a trust qualify for any of the tax-free allowances offered to natural persons, such as the savings interest allowance, dividend allowance, trade allowance or property allowance, to name a few.[188] Conversely, beneficiaries of a fixed or an interest in possession trust can utilise some of these allowances, depending on their income band and personal circumstances.[189] Trustees are nevertheless permitted to claim the relevant tax deductions for which the trust qualifies if said deductions are properly proportioned between income, capital or both.[190] The general rule is that the expenses are assigned to the group of beneficiaries who enjoy the benefit of same. However, trust management expenses do not constitute a valid deduction for tax purposes unless one of the exceptions applies.

With the acceleration of the global transparency movement and the increased support for the various initiatives aimed at curbing harmful tax practices, coupled with an onslaught of negative media attention, there has been a renewed focus on scrutinising trusts and how trusts are potentially used to facilitate devious transactions.

In light of the former, the UK has enacted a range of amendments to the trust regime. Most of these reforms are aimed at stricter regulatory oversight and increasing the disclosure requirements for trusts and those who are parties to trusts. The introduction of the trust register forms the core of the UK's drive to improve

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184 Chamberlain & Whitehouse *Trust Taxation* 12.
185 23.
186 Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.1.
187 Chamberlain & Whitehouse *Trust Taxation* 23.
188 Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.86.
189 Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 56.1.
190 Para 56.1.

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transparency and also to curb money laundering and terrorist finance activities.[191] Her Majesty's Revenue and Customs ("HMRC") is tasked with controlling and administering the registry. The trusts registry functions similarly to the company's registry, which is operated and maintained by the Companies House, but access to the information is much more restricted. Registration is mandatory for all express trusts formed under UK law, with specific limited exceptions.[192] Aside from the former category, all UK trusts, which have some form of tax liability in the UK, are also obligated to register.[193]

In general, the trust register contains information in relation to the trust, the trustees, the beneficial owners (the settlor and beneficiaries) and the trust assets.[194] Under certain circumstances, it may be required to provide additional information or to elaborate further on a specific aspect.

As a point of departure, the trustees receive all trust income, regardless of whether they are beneficially entitled to said income.[195] Trustees are further taxed on any distributions made to beneficiaries.[196] Depending on the trust type, different rules may be applicable. Beneficiaries are, in turn, taxed on the income received.[197] Under certain circumstances, the beneficiary can receive the income directly, thereby circumventing the income flowing through the trust.[198] In other cases, it is also possible that income is deemed to be that of the settlor, even though the settlor has not received the income.[199] In such cases, the trustees will still pay the tax liability, but it is taxed in the hands of the settlor, who bears the ultimate responsibility. In all of the scenarios above, an appropriate tax credit is provided to relieve possible double taxation.

Both UK resident trustees and beneficiaries are liable to tax on their worldwide receipts and accruals, whereas non-resident trustees and beneficiaries' tax liabilities are typically limited to UK source income.[200] This means that a UK resident

[191] Chamberlain & Whitehouse *Trust Taxation* 24.
[192] 27.
[193] 27.
[194] Maston *Tolley's UK Taxation of Trusts 2018-19* para 1.19.
[195] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.2.
[196] Chamberlain & Whitehouse *Trust Taxation* 8.
[197] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.1.
[198] Chamberlain & Whitehouse *Trust Taxation* 29.
[199] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.3.
[200] Chamberlain & Whitehouse *Trust Taxation* 134.

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beneficiary, which is also a beneficiary of a non-resident trust, may also be liable to tax on amounts distributed to it from the non-resident trust.

Under specific conditions, beneficiaries may be entitled to use the special basis of taxation, known as the remittance basis.[201] This is opposed to the ordinary bases of taxation, also referred to as the arising basis.[202]

It is vital to remember that income will always only be taxed once. Even though the income may be subjected to tax on multiple fronts, the tax credits received essentially counter-acts double taxation from occurring. This illustrates that the UK subscribes to the policy stance that trust income should only once be subjected to taxation throughout the trust relationship.

4 4 2 Determining residence status

Under UK law, the extent of one's tax obligations hedges on an individual's residency status and domicile.[203] The combination of these factors determines which income is subjected to which taxes. For this reason, understanding both these concepts and their effects on one's personal circumstances is paramount. The UK uses a residency-based taxation system, which means that UK residents are taxed on worldwide income. Conversely, non-residents are only liable to tax on income derived from a source in the UK.[204] However, there are some exceptions to this rule.

The test for determining a person's residency status depends on the type of person they are considered to be for tax purposes.[205] The legislation distinguishes between natural persons, such as individuals, and legal persons, such as companies.[206] There is no separate test for so-called opaque entities such as trusts, but in such a case, one rather looks to the underlining parties to establish its residency status.

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[201] Maston *Tolley's UK Taxation of Trusts 2018-19* para 28.3.
[202] Para 25.4.
[203] Booth *Booth and Schwarz: Residence, Domicile and UK Taxation* 1-2.
[204] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 11.1.
[205] Chamberlain & Whitehouse *Trust Taxation* 42.
[206] Maston *Tolley's UK Taxation of Trusts 2018-19* para 1.14.

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4 4 2 1 Individuals

In the case of individuals, a person will be regarded as a resident for tax purposes if the person complies with the statutory residence test ("SRT"), which was introduced with the aim to clarify and simplify the requirements, and is effective from 2013.[207] Prior to the enactment of the SRT, the relevant tests and supporting factors were contained in a mixture of case law, statutes and HMRC guidance notes. Notwithstanding the UK government's intentions with the SRT, the series of tests that need to be considered are very complex and require attention to detail.

The SRT consists of the following three main tests to ascertain whether or not an individual is resident in the UK for a particular tax year:[208]

1. an automatic overseas test;
2. an automatic residence test; and
3. the sufficient ties test.

The SRT operates through a hierarchical structure, where the first test is considered in its entirety before one continues to the next test. Only if the current test fails will the enquiry progress to the subsequent tests. If one of the tests is satisfied, the enquiry is halted, and the person is classified according to the conclusion reached.

If a person complies with any of the automatic overseas tests, the individual is automatically regarded as a non-resident for that tax year. In such a case, which is the end of the enquiry, none of the other tests needs to be considered. However, if none of the automatic overseas tests is satisfied, the enquiry's focus must shift to the automatic residence tests. If one of these tests is met for a particular year, said person will be regarded as a UK resident for that specific tax year. If none of these tests is fulfilled, the enquiry must continue with the sufficient ties test.

If a person does not comply with either the automatic resident tests or the sufficient ties test, such person is considered a non-resident for UK tax purposes in that tax year.

[207] Booth *Booth and Schwarz: Residence, Domicile and UK Taxation* 30.
[208] 31-32.

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4 4 2 2 Companies

Conversely, where legal persons are concerned, under the UK's domestic rules, a company is tax resident in the UK if one of the following applies:[209]

1. incorporated in the UK; or
2. centrally managed and controlled in the UK

UK tax laws provide that if a company is incorporated in the UK, it is automatically regarded as a resident in the UK for tax purposes.[210] In such a case, this is the end of the enquiry, and it is not necessary to consider where it is centrally managed and controlled ("CMAC"). Notwithstanding the aforementioned, foreign companies, or companies that are not incorporated in the UK, are nonetheless UK resident if it is shown that their place of CMAC is in the UK. In this context, the definition of the "United Kingdom" means Great Britain and Northern Ireland but excludes the English territories or crown dependencies.[211]

The meaning of CMAC is derived from case law. It is directed at the highest level of control of a company's business. It is a question of fact and largely revolves around who exercises this control and in what geographic location it takes place. It is an objective, but evidence-driven determination, and all factors and supporting documents must be taken into account.

In *De Beers Consolidated Mines v Howe (Surveyor of Taxes)*,[212] the court held that "the business is carried on where the central management and control actually abides". This formulation served as the basis of a line of cases that developed over the years. In the subsequent cases, the courts considered the question of corporate residency under a range of circumstances and expanded the tests used, identified the relevant factors, and provided guidance on the interpretation of some of the aspects.

In *HMRC v Development Securities PLC*,[213] the court outlined a number of practical considerations that must be taken into account and summarised the case law position on CMAC. First, the court confirmed that the question of where the CMAC abides is one of fact. In other words, the CMAC is where it actually is and not where it

[209] 196.
[210] KM Gordon & XM Manzano *Tiley and Collison's UK Tax Guide 2018-19* 34 ed (2019) para 29.7.
[211] Para 29.7.
[212] (1) (1903-1911) 5 TC 198.
[213] [2020] EWCA Civ 1705.

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ought to be. Following this line of thought, the court described the CMAC as the place where the company's "paramount authority" is exercised. Under most conditions, this role is fulfilled by the board.

The court further held that a "substance over form" approach should be closely related to the above. This means the courts will take a holistic view and disregard any shams. Moreover, the courts must be cognisant of the possibility that exists that the board merely rubber stamps decisions taken by others. To this extent, the court emphasised that influence and wishes are not the same as management and control.

Finally, the case also considered what may constitute rubber stamping. The court described it as a situation where the board simply approves decisions without applying their minds to the problem at hand. This often occurs when the company's shareholders take decisions, and the board is just the company's face, which acts as a puppet and implements the shareholder's decisions accordingly. In such a , the CMAC is really being exercised by the shareholders and not the company's board. The following scenarios are signs that rubber stamping may be taking place:

1. where the board ignores its statutory duties when taking company decisions; or
2. where the board knowingly acts without sufficient information.

4 4 2 3 Trusts

In the UK, it is not the trust or the settlement that is resident for tax purposes but rather the body of trustees.[214] This arises from the way in which UK trusts are regarded for tax purposes. It will be recalled that trustees are treated as a single notional person, distinct from the persons who make up the trustees.

To determine the trust's residency status, one needs to ascertain the residency status of the trustees and that of the settlor.[215] Under certain circumstances, the settlor's domicile is also important. Based on the aforementioned outcome, the trust is either classified as resident or non-resident for UK tax purposes.[216]

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[214] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.2.
[215] Maston *Tolley's UK Taxation of Trusts 2018-19* para 24.22.
[216] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.2.

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Under UK trust law, both natural and legal persons can be a trustee of a trust.[217] In practice, one often finds that the board of trustees are comprised of both. Therefore, the type of trustees will determine what test should be applied.

If all the trustees of the trust are resident in the UK, the trust is regarded as a UK resident for tax purposes.[218] Conversely, if all the trustees are resident outside the UK, the trust is classified as a non-resident.[219]

In the instance that some of the trustees are resident in the UK, and others are resident outside the UK, the default position is that the trust is UK resident for tax purposes unless the settlor was neither resident in the UK nor domiciled in the UK at the time the settlor made, or is treated as making, the settlement and any time when the settlor adds property to the settlement.[220] In such a case, the trust is also regarded as non-resident. If the settlement arises on a settlor's death, the settlor's residence and domicile status are considered immediately before death.[221]

4 4 3 The conduit pipe principle

Unlike other commonwealth countries that recognise and follow the conduit pipe principle, whereby income received by a trust retains its identity until it reaches the hands of the ultimate beneficiary, generally speaking, the UK has not adopted this common-law principle into their law, with the exception of some specific cases. As encountered throughout the trust taxation landscape, different rules apply to the various trust types.[222] Where discretionary trusts are concerned, legislation provides that if the trustees exercise their discretion in favour of said beneficiary, the income distributed by the discretionary trust to the beneficiary loses the income's original source, and from there on, the trust is regarded as the source of the income.[223] Hence, the beneficiary cannot look through to the trust's underlying assets. This means that no distinction is made between dividend income, savings income and other income in the beneficiary's hands. All such distributions are taxable as annual payments in the hands of the beneficiary, regardless of the type of income received by the trust. Any

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[217] Hudson *Equity and Trusts* 39.
[218] Maston *Tolley's UK Taxation of Trusts 2018-19* para 31.10.
[219] Para 31.10.
[220] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 62.2.
[221] Maston *Tolley's UK Taxation of Trusts 2018-19* para 24.3.
[222] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.1.
[223] Maston *Tolley's UK Taxation of Trusts 2018-19* para 2.31.

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distribution made by a UK resident trust will be regarded as UK source income in the beneficiaries' hands.[224]

Subject to the fulfilment of specific requirements, under certain circumstances, it is possible for a beneficiary of a UK resident discretionary trust to claim that the payment of an amount was received directly by the beneficiary and not by the trust.[225] Such a provision aims to prevent double taxation from occurring. Furthermore, provided certain conditions are met, HMRC will permit a beneficiary of a UK resident discretionary trust to claim an exemption or relief if the trustee made an income distribution from the trust, in respect of which, had it been received directly by the beneficiary, the beneficiary would, *among others:*

1. have been entitled to relief under the terms of a double tax treaty; or
2. not have been liable to UK tax as a result of their non-resident and/or not ordinarily resident status.[226]

Following from the former, relief is also available for a non-resident beneficiary who receives a payment from a non-resident trustee if all the requirements and conditions are met.[227]

However, if the trustee decides to retain income as part of the trust's capital, the accumulated sum loses its character as income and is treated as capital.[228] Therefore, any subsequent distribution to the beneficiary is not subject to income tax but may have CGT consequences.[229]

Conversely, the rules applicable to fixed or interest in possession trusts differ somewhat from that of discretionary trusts discussed above. If trustees of a fixed or an interest in possession trust pass income on to the beneficiaries, such income will retain its original character in the hands of the beneficiaries.[230] This is the position regardless of the trust configuration, as long as the beneficiaries have a vested right to the trust's income. The key criterion is entitlement to income and not just receipt.[231]

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[224] Gordon & Manzano *Tiley and Collison's UK Tax Guide 2018-19* para 55.24.
[225] Section 111 of the Taxation (International and Other Provisions) Act 2010.
[226] Her Majesty's Revenue and Customs *Extra-Statutory Concessions* B18; Chamberlain & Whitehouse *Trust Taxation* para 6.40.
[227] Her Majesty's Revenue and Customs *Extra-Statutory Concessions* B18.
[228] Chamberlain & Whitehouse *Trust Taxation* para 6.38.
[229] Para 6.38; Gordon *& Manzano Tiley and Collison's UK Tax Guide 2018-2019* para 21.18.
[230] Gordon *& Manzano Tiley and Collison's UK Tax Guide 2018-2019* para 28.18.
[231] Para 28.18.

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Therefore, the beneficiary does not have to receive the income for it to be assessed to them – for example, it may be accumulated within the trust but held for their sole future benefit. Thus, it is possible that the beneficiaries are liable to tax upon income that they will only receive in subsequent years.

For beneficiaries under a UK trust, the source of the income is determined by the trust's underlying assets instead of the trust itself.[232] This is also the rule for certain other jurisdictions aside from the UK, which are collectively called "Baker jurisdictions".[233] In contrast, "Garland jurisdictions" refers to those jurisdictions where the beneficiaries do not have a specific interest in each and every trust asset but rather an interest in the trust itself. [234] Therefore, the trust is seen as the source of the income.[235] However, academics are divided on the correctness of this rule, and some courts have even questioned whether it should always apply. [236]

4 4 4 The taxation of the trust parties

Although UK law recognises various trust types,[237] each serving a specific purpose and having a unique application, the relevance of the distinction is much more limited for tax purposes. In the income tax realm, one must differentiate between two broad categories of trust types, which are taxed according to different rules, namely:[238]

1. discretionary trusts; and
2. fixed or interest in possession trusts.

In the case of discretionary trusts, the income may be subject to accumulation or to distribution at the trustees' discretion, in line with the wishes of the settlor and the prescripts of the trust instrument, for which a special income tax regime applies.[239] Up until the point that the trustees have exercised their discretion, the beneficiaries will

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[232] Para 7.16.
[233] *Baker v Archer-Shee* [1927] AC 844 HL.
[234] *Archer-Shee v Garland* (1931) 15 TC 693.
[235] Chamberlain and Whitehouse *Trust Taxation* para 6.15; Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.1.
[236] Chamberlain and Whitehouse *Trust Taxation* para 6.16; Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.
[237] Hudson *Equity and Trusts* 40.
[238] Maston *Tolley's UK Taxation of Trusts 2018-19* para 2.30.
[239] Para 2.1.

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only have a hope to receive the income and, consequently, no form of entitlement or claim to the trust income.[240]

In the UK, discretionary trusts are taxed in accordance with a three-tiered system, which can be summarised as follows:[241]

1. a charge on the trustee on the receipt of the income;
2. a charge on the trustee on making a discretionary payment of income; and
3. a charge on the beneficiaries on receiving a discretionary payment of income.

Even though the income is taxed on different levels, the UK still subscribes to the policy view that trust income must only be subjected to taxation once throughout the trust relationship.[242] This is achieved by providing appropriate tax credits to relieve possible double taxation.

Where fixed or interest in possession trusts are concerned, the income belongs to the beneficiaries as it arises, in accordance with the stipulations of the trust deed.[243] Thus, the beneficiaries are already entitled to the income and are not subjected to the discretion of the trustees. Many varieties and derivatives are available, depending on the specific circumstances of the parties.[244] Notwithstanding the configuration, the overarching category is largely treated the same for income tax purposes.

Unlike the income tax regime, all types of trust are treated in the same way for CGT purposes.[245] For inheritance tax, the principal distinction is between a "qualifying interest in possession", under which the capital of the trust is treated almost as if the beneficiary owned it; and the "relevant property" regime, which has a separate system of ten-year and exit charges.[246] However, these latter taxes are beyond this dissertation's scope and are discussed no further.

4 4 4 1 The trustees

Under UK tax law, the point of departure is that whoever receives the income, or for whose benefit the income is accrued, that person constitutes the assessable party and

[240] Para 2.1.
[241] Para 2.34.
[242] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.3.
[243] Chamberlain and Whitehouse *Trust Taxation* para 6.04.
[244] Para 6.04.
[245] Maston *Tolley's UK Taxation of Trusts 2018-19* para 5.21.
[246] Chamberlain and Whitehouse *Trust Taxation* para 9.09.

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is subsequently liable to settle any tax obligations in respect of said income.[247] The only caveat to the aforesaid is if an anti-avoidance rule catches the income. In the context of trusts, the trustee is legally entitled to the income and also the person who receives the trust's income.[248] The trustee is not beneficially entitled to said income but merely the one who receives and administers it for the benefit of the trust's beneficiaries.[249] This general rule makes trustees assessable for tax purposes, but there are no separate charging provisions for trusts. Hence, the usual charging provisions will apply.

This means that a UK resident trustee is subject to tax on all of his income, while a non-resident trustee is, generally speaking, only subject to tax on income from a UK source.[250] However, depending on the exact circumstances and the trust type, one of the exceptions may be applicable.

For tax purposes, trustees are not classified as individuals. This means that the trustees cannot claim any personal reliefs, such as the basic income exemption, or any other allowances available to individual taxpayers.[251] Furthermore, only individuals are subjected to tax at a higher or additional rate. Thus, the general rule is that trustees are assessable at the basic rate of 20% on most income and a basic rate of 7.5% on dividend income.[252] However, for accumulated or discretionary income, higher special rates apply. [253]

In the case of discretionary trusts, none of the beneficiaries is entitled to the income unless the trustees make a distribution to that effect.[254] To prevent income from slipping through the tax net, the tax system operates to ensure that all possible taxes due are collected at a trustee level. As such, trustees are liable to tax on all the income *due* to the trust, whether or not the trustees receive it.[255] Subject to the standard rate exemption, this ensures that trustees pay income tax at the highest possible marginal rate – being, 38.1% for dividend income and 45% for all other income. This means that the trustees are taxed in the same way and to the same

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[247] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.9.
[248] Gordon *& Manzano Tiley and Collison's UK Tax Guide 2018-2019* para 24.8.
[249] Hudson *Equity and Trusts* 51-52.
[250] Booth *Booth and Schwarz: Residence, Domicile and UK Taxation* 86.
[251] Section 24 of the ITA7.
[252] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.52.
[253] Section 480 of the ITA7.
[254] Chamberlain and Whitehouse *Trust Taxation* para 6.04.
[255] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.2.

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extent regardless of the beneficiaries' personal circumstances.[256]

The standard rate exemption provides that the first £1000 of income is taxed at the basic rates,[257] and any subsequent income over this threshold is taxed at the special rates as described above. As an anti-avoidance measure, the £1000 allowance is divided equally among all the settlements made by the same settlor.[258] The trustees are, however, permitted to deduct qualifying expenses when calculating the £1000 threshold.

In addition to the charge on the trustees at the receipt of the income, the trustees are further taxed when applying their discretion to distribute income to the beneficiaries. The relevant provision reads as follows:

> "(1) The discretionary payment is treated as if it were made after the deduction of a sum representing income tax at the trust rate on the grossed up amount of the discretionary payment.
>
> (2) The grossed up amount of the discretionary payment is the actual amount of the discretionary payment grossed up by reference to the trust rate.
>
> (3) The person mentioned in subsection (4) is treated as having paid income tax of an amount equal to the sum deducted as mentioned in subsection (1).
>
> (4) That person is—
>
> (a) if condition A in section 493 is met, the beneficiary, and
>
> (b) if condition B in section 493 is met, the settlor."[259]

If the trustees make any discretionary payment of income to beneficiaries, it is treated by the beneficiaries as if income tax has already been paid at the special rate of 45%.[260] The trustees are, therefore, liable to the tax of 45%, regardless of the type of income received. Moreover, the actual *rate of tax paid by the trustees is irrelevant to the beneficiaries. Should the tax rate on the specific income be below 45%, the trustees are liable to pay the difference.*[261] This means the beneficiary could claim

[256] Gordon *et al Tiley and Collison's UK Tax Guide 2018-2019* para 6.29.
[257] Section 491 of the ITA7.
[258] Section 492.
[259] Section 494.
[260] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.52.
[261] Para 6.52.

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some or all of the tax back if they are a non-taxpayer or if they fall within the lower bands.

When trustees make a payment, they must have paid enough income tax to cover the 45% tax charge. The tax pool keeps track of all the income tax paid by the trustees since the formation of the trust.[262] If the tax charge on payments to beneficiaries cannot be covered by the amount of tax recorded in the tax pool, the trustees must pay the difference. For this reason, it is important that the trustees plan accordingly to avoid potential problems. The relevant section, which outlines the trustees' liability to income tax, reads as follows:

> "(1) Income tax is charged for a tax year if—
>
> (a) in the tax year the trustees of a settlement make payments as a result of which income tax is treated as having been paid under section 494, and
>
> (b) Amount A is greater than amount B.
>
> (2) Amount A is the total amount of the income tax treated under section 494 as having been paid.
>
> (3) Amount B is the amount of the trustees' tax pool available for the tax year. [263]
>
> (4) The amount of the tax charged under this section is equal to the difference between amounts A and B.
>
> (5) The trustees are liable to the tax."[264]

The tax pool is a record that the trustees need to keep to show, at the end of a given tax year, the difference between the: [265]

1. the total income tax entering the tax pool that year, plus the amount carried over in the tax pool from earlier years; and
2. the total value of the 45% tax charge, which is attached to income payments to beneficiaries for that year.

When the trustees pay tax at the special trust rates, the tax pool increases by the amount of tax paid. This can vary between 7.5% and 45%, depending on the type of

[262] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.2.
[263] Section 497 of the ITA7.
[264] Section 496.
[265] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.67.

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income received, as well as the total income of the trust for that year.[266] Thus, each time the trustees distribute income to the beneficiaries, the amount in the tax pool is subsequently reduced. [267] The 45% tax charge is subtracted for every payment made from the available tax pool.

If there is a positive balance remaining at the end of the tax year, such amount constitutes the tax pool of that year. The balance is carried forward to the next year of assessment and can be offset against future payments. The following provision outlines the calculation in more detail:

> "(1) Take the following steps to calculate the amount of the trustees' tax pool available for a tax year ("the current tax year"). This is subject to subsections (2) and (3).
>
> Step 1 Take the amount of the trustees' tax pool available for the previous tax year and deduct from that amount (but not so that it goes below nil)
>
> (a) the total amount of income tax treated under section 494 as having been paid as a result of payments made by the trustees in the previous tax year, and
>
> (b) the amount to which the trustees are entitled under section 496B in respect of the previous tax year.
>
> Step 2 Add together all amounts of income tax for which the trustees are liable to the current tax year and which are of a type set out in section 498. Step 3 Add the sum calculated at Step 2 to the amount resulting from Step 1.
>
> (2) If the trustees were non-UK resident for the previous tax year, references in subsection (1) to the previous tax year are to be read as references to the last tax year prior to the current tax year for which the trustees were UK resident.
>
> (3) If—
>
> (a) the current tax year is the tax year during which the settlement is established, or
>
> (b) the trustees have been UK resident for no tax year prior to the current tax year, ignore Steps 1 and 3 and, accordingly, the trustees' tax pool available for the current tax year is the sum calculated at Step 2."[268]

Unlike discretionary trusts, income under fixed or interest in possession trusts is already allocated to the various beneficiaries.[269] Hence, the entitlement to the income

[266] Gordon & *Manzano Tiley and Collison's UK Tax Guide 2018-2019* para 39.1.
[267] Para 39.1.
[268] Section 497 of the ITA7.
[269] Chamberlain & Whitehouse *Trust Taxation* para 6.29.

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is already established without requiring any eventuality to occur. This means that the *ultimate* income tax liability will be determined by the recipient beneficiary's personal tax position. However, the trustees are themselves still liable to income tax on any income *received,* but only at the *basic rates.*[270] The trustees are also able to *mandate* income directly to a beneficiary.[271] In such a case, the trustees have no income tax liability, and the beneficiary is simply taxed directly in relation to the income received.

4 4 4 2 The beneficiaries

Similar to the position of the trustees, UK resident beneficiaries are subjected to tax on their worldwide income,[272] whereas non-resident beneficiaries are, generally speaking, only liable to tax in respect of income from a source in the UK.[273]

For discretionary trusts, income distributed to the beneficiaries is further subjected to a tax charge in the hands of the beneficiaries. However, the beneficiaries are entitled to a tax credit equal to the income tax that has already been paid by the trustees when making the distribution.[274] Therefore, the beneficiaries can offset the 45% tax credit against their personal tax liability on the trust income, which in effect, should result in a tax rebate unless the beneficiaries are subject to income tax at the additional rates. Non-resident beneficiaries can only receive the tax credit if the trustee is resident in the UK.[275]

The income is said to be received by the beneficiaries, either on the date that the trustee makes the payment or on the date that the beneficiaries become legally entitled to compel the trustee to pay over the income.[276] The latter occurs when the income is no longer contingent on some eventuality; instead, the beneficiaries are fully entitled to the income. In addition, any income distributed from the trust no longer retains its original character in the hands of the beneficiaries but is instead classified as an annual payment.[277] The fact that the income does not retain its character means that

[270] Gordon *& Manzano Tiley and Collison's UK Tax Guide 2018-2019* para 59.2.
[271] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 39.1.
[272] Income Tax (Trading and Other Income) Act 2005 ss 577(1) and 683(1); Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 32.1.
[273] Section 577(2) of the Income Tax (Trading and Other Income) Act 2005.
[274] Sections 493-494 of the ITA7; Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 32.1.
[275] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.60.
[276] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 32.1.
[277] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.87.

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a beneficiary cannot take advantage of the *personal savings* or *dividend* allowances.[278]

In the case of fixed or interest in possession trusts, the beneficiaries are also assessed on the income received. Depending on the beneficiaries' personal circumstances, an extra tax liability can arise if the beneficiary is liable to tax in accordance with the higher rate band or the additional rate band.[279] If the trustee received the amount with the tax deducted at source, or if the trustee has paid the tax on the income, the beneficiary is given credit for that tax already paid.[280] However, this will always be limited to the basic rates. In the instance that the trustee mandates the income to the beneficiary, it is the beneficiary that is taxed on said income.[281] Moreover, if income is received from abroad, the UK resident trustee is not liable to tax if that income is paid to a non-resident beneficiary.[282]

Unlike discretionary trusts, the income passed on from the trust to the beneficiary keeps its character in the hands of the beneficiary.[283] This means that the beneficiaries are able to utilise their personal allowances.

4 4 4 4 The settlor

Under UK trust law, the settlor's role ceases to exist after the trust is duly formed and all regulatory requirements are met, whereafter the trustees take over the management and administration of the trust.[284] Hence, for income tax purposes, it is not surprising that the settlor is not typically a taxable party in the trust relationship unless the settlor also serves as a trustee or if the settlor is a beneficiary under the trust, in which case, income is taxed in the hands of said capacity in accordance with the usual rules as outlined and discussed above.

However, under certain conditions, the trust's income will be deemed to be that of the settlor for income tax purposes, even though the income is, in actual fact, neither received by nor accrued to the settlor.[285] In such a case, the settlor will be assessed

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[278] Gordon *& Manzano Tiley and Collison's UK Tax Guide 2018-2019* para 12.9.
[279] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.61.
[280] Chamberlain and Whitehouse *Trust Taxation* para 6.26.
[281] Her Majesty's Revenue and Customs *Manual on Trusts* para TSEM3765.
[282] Her Majesty's Revenue and Customs *Manual on Trusts* para TSEM3160.
[283] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.61.
[284] *Kessler Taxation of Non-Residents and Foreign Domiciliaries para 33.1.*
[285] Chamberlain and Whitehouse *Trust Taxation* para 1.14.

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on said income and consequently be liable to the tax obligation that may arise.

If one of the following anti-avoidance provisions is applicable, the income will be taxed in the settlor's hands and not in the hands of the person who received said income:[286]

1. settlor-interested trusts; or
2. payments to the settlor's child.

The above-mentioned scenarios are discussed in more detail in chapter 5, in the context of anti-avoidance measures. Notwithstanding, some key points pertinent to the taxation of trusts are highlighted below.

Under a discretionary or accumulation and maintenance trust, despite the settlor being assessed, the trustees are liable to tax at the trust rates, thus, effectively paying tax on behalf of the settlor, and the settlor is subsequently entitled to a credit for the tax paid by the trustees.[287] If the settlor is not an additional rate taxpAayer, any excess tax paid by the trustees may be reclaimed.[288] Any such refund must be paid back to the trust by the settlor.

If income is distributed from a settlor-interested trust to a beneficiary, that beneficiary will have no income tax liability in respect of the trust income on the condition that said beneficiary is not also the settlor.[289] However, it will still count as the highest part of the beneficiary's income and so can still affect the calculation of tax on certain other income received. Therefore, this means that payments to beneficiaries of settlor-interested trusts are treated differently from other payments, as they do not carry a tax credit at the trust rate.

In the case of a non-resident settlor, only income from a UK source is treated as the settlor's income.[290] Thus, if the trust is resident in the UK, but the settlor is not, the trust is taxed in full on the income that is not of a UK source, while the settlor is taxed on the income that is from a UK source. If both the trust and the settlor are non-

[286] Maston *Tolley's UK Taxation of Trusts 2018-19* para 4.37.
[287] Para 11.23-11.24.
[288] Chamberlain and Whitehouse *Trust Taxation* para 1.14.
[289] *Kessler Taxation of Non-Residents and Foreign Domiciliaries para 33.3.*
[290] Gordon & *Manzano Tiley and Collison's UK Tax Guide 2018-2019* para 37.32.

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residents, neither is taxed on income that is not from a UK source, but the settlor will be taxed on income that is from a UK source.[291]

4 4 5 The UK GAAR

Initially, the UK did not have a formal GAAR. Instead, HMRC relied on the principles formulated by the courts. However, in 2013 the legislative GAAR was introduced to deter taxpayers from using tax avoidance schemes. But, the GAAR is referred to as a general anti-abuse rule,[292] which is much narrower than a GAAR. Notwithstanding this, the effect is the same; hence, the terms will be used interchangeably. Nevertheless, the following discussion merely intends to provide a high-level overview of the UK's GAAR and not an in-depth analysis of the topic.

As a point of departure, the GAAR provides a statutory mechanism for HMRC to counteract tax avoidance arrangements which, although within the letter of the law, such arrangements are not what was intended.[293]

This means that the GAAR forms part of the UK's anti-avoidance framework but takes priority over other parts of tax legislation.[294] Thus, the GAAR functions in conjunction with other anti-avoidance measures, which include the following:

1. specific anti-avoidance rules;
2. judicial doctrines; and
3. disclosure rules.

"Arrangement" is defined widely as including "any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable)" while a "tax arrangement" means any arrangement that, when viewed objectively, aims to obtain a tax advantage as its main purpose or one of its main purposes.[295]

A "tax advantage" is broadly defined to include the following:[296]

1. any relief from tax;
2. repayment of tax;

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[291] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 21.6; Chamberlain & Whitehouse *Trust Taxation* para 7.20.
[292] Section 206(2) of the Finance Act 2013.
[293] Section 206(2).
[294] Section 212.
[295] Section 207(1)
[296] Section 208.

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3. avoidance, or reduction of a charge to tax;
4. avoidance of a possible assessment of tax;
5. a deferral of a payment of tax; or
6. avoidance of an obligation to deduct or account for tax.

In light of the above, it is clear that the wide ambits of the definitions set a low threshold for considering the possible application of the GAAR. However, for any arrangement to be caught, the tax arrangement must also be "abusive". Thus, before the GAAR can apply, it is necessary to determine if the arrangements constitute an abusive tax arrangement.

The GAAR defines abusive' by reference to a test known as the double reasonableness test, which states that tax arrangements are abusive if, having regard to all the circumstances, entering into the arrangements or carrying them out cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions.[297]

This means it is an objective test that requires consideration:

1. of whether the tax arrangements are, having regard to all the relevant circumstances, a reasonable course of action; and
2. in turn, if that view is itself reasonable.

The burden of proof is on HMRC to show that the arrangements are abusive.[298] But, tax arrangements are not protected from the GAAR's application just because someone believes that the arrangements are a reasonable course of action. That person's view must also be reasonable. Similarly, just because a view is commonly held does not make it reasonable.

When considering whether tax arrangements are regarded as abusive for the purposes of the GAAR, all the surrounding circumstances need to be taken into account, including:[299]

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[297] Section 207(2).
[298] Section 211(1).
[299] Section 207(2).

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1. whether the substantive results of the arrangements are consistent with any principles on which those provisions are based, whether express or implied and the policy objectives of those provisions;
2. whether the means of achieving those results involves one or more contrived or abnormal steps; and
3. whether the arrangements are intended to exploit any shortcomings in those provisions.

Possible factors which may strongly indicate that the arrangements are abusive include the following: [300]

1. where the arrangements result in income, profits or gains for tax purposes that are significantly less than the amount for economic purposes; or
2. where the deductions or losses for tax purposes are significantly greater than the amount for economic purposes.

However, the fact that tax arrangements accord with established practice, and HMRC had, at the time the arrangements were entered into, indicated its acceptance of that practice, might indicate that the arrangements are not abusive.[301]

HMRC's guidance gives examples of how the definition of abusive arrangements will be applied in practice. This confirms that where the tax legislation reflects a clear policy of providing tax relief or other specified outcomes, reasonable steps taken to achieve the outcomes expected from those rules or to prevent benefits from being inappropriately denied will be a reasonable course of action in relation to those rules.[302] It also confirms that if the legislation contemplates that a taxpayer can exercise a range of different commercial or personal choices, each involving different tax consequences, it would be entirely reasonable for the taxpayer to take the tax considerations into account when deciding the course of action to take.[303]

[300] Section 207(4).
[301] Section 207(5).
[302] HM Revenue & Customs "Tax avoidance: general anti-abuse rule guidance- latest version" (16-07-2021) *HMRC* <https://www.gov.uk/government/publications/tax-avoidance-general-anti-abuse-rules> (accessed 09-12-2022).
[303] HM Revenue & Customs "Tax avoidance: general anti-abuse rule guidance- latest version" 16-07-2021) *HMRC*.

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Moreover, there is an independent GAAR Advisory Panel, and HMRC must seek the opinion of this Panel in respect of what HMRC considers to be abusive arrangements.[304] Although the opinion of the Panel is not binding on HMRC, it will form part of the evidence in any subsequent hearing.[305]

Where the GAAR applies, HMRC will be entitled to counteract the abusive tax arrangement in a just and reasonable manner to recover any revenue that has been lost.[306] This will usually be achieved by issuing or modifying assessments or disallowing or amending claims.[307]

There is further no clearance procedure available for the GAAR. Notwithstanding, taxpayers are still required to assess their tax liability in accordance with the GAAR and, if the GAAR applies, to make any necessary adjustments before submitting their tax returns or paying taxes. This follows from the notion that taxpayers are required to self-assess their UK tax liabilities in accordance with the UK's tax rules. The GAAR merely forms part of those rules and therefore needs to be considered for a taxpayer to determine its liability to UK tax. Furthermore, incorrectly assessing one's tax liability may lead to interest and penalties being levied.

Despite the potential adverse consequences that may follow if the GAAR is invoked, in practice, most taxpayers will not self-assess the GAAR since it is unlikely that they would carry out a transaction that they think would be subject to the GAAR only to have to make subsequent adjustments.

For this reason, the legislation also enables HMRC to apply the GAAR. However, HMRC is only permitted to counteract abusive tax advantages if certain procedural steps are followed.[308] The procedural steps differ depending on what type of notice HMRC gives the taxpayer. But, a discussion of these aspects falls outside this dissertation's scope and will not be discussed.

In addition, the adjustments made to counteract the abusive tax advantage may be made in respect of:[309]

[304] Section 211(2) of the Finance Act 2013.
[305] Section 211(3).
[306] Section 209.
[307] Section 209(5).
[308] Section 209(6).
[309] Section 209(3).

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1. the tax in respect of which an abusive tax advantage would, in the absence of the GAAR, have been obtained; or
2. any other tax to which the GAAR applies; and
3. must be made on a just and reasonable basis.

In many cases, determining what adjustments are just and reasonable might be fairly simple, such as where the amount of taxable income could simply be increased, a deduction decreased, or circular transactions ignored.[310] However, in more complicated circumstances, determining what adjustments to make, requires considering the difference in the tax result between the abusive transaction that was carried out and another hypothetical non-abusive transaction designed to achieve the same commercial or non-tax purpose but that excludes the abusive tax-related features. Nevertheless, the comparable non-abusive transaction is not necessarily the one that would give rise to the highest tax charge, but judged on an objective basis, should be the one that the taxpayer would have been most likely to have carried out if it was not for the tax-abusive features.

Given that the GAAR is targeted at tax abuse and not tax avoidance, HMRC may continue to challenge tax avoidance under any existing anti-avoidance rules, including any principles developed through case law.

4 5 Belgium

4 5 1 General principles

As previously discussed,[311] Belgium is a civil law jurisdiction and is not familiar with the common-law trust concept under Belgium law.[312] This phenomenon is not unique to Belgium but is the case with the majority of civil law countries.[313] Instead, under Belgium's domestic law, the country has so-called trust-like entities, but in actual fact, these entities are far from real trusts.[314] Although it is impossible to create a trust under

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[310] Section 209(4).
[311] See paragraph 2 4 above.
[312] J-M Tirard *The Global Guide to Trusts* 2 ed (2020) 4.
[313] N Appermont, C Costermans, E D'Hauwe, F Debelva, B Peeters, S Slaets, F Smet, AM Vandekerhove, L Vanneste, G Verachtert & V Vercauteren *De Kaaimantaks: Panta rhei* (2019) 28; P Hefti "Trusts and their Treatment in the Civil Law" (1956) 5 *TAJoCL* 553 558.
[314] Appermont et al *De Kaaimantaks: panta rhei* 29.

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Belgium law, Belgium recognises the existence of foreign trusts.[315] This is despite the fact that Belgium has neither signed nor ratified the Hague Convention of 1 July 1995 relating to the law applicable to trusts and their recognition. The International Private Law Act of 16 July 2004 ("IPLA") introduced a legal definition of a trust in Belgian law. Accordingly, a trust is defined as:

> "a juridical relationship created by an act of the founder or by a juridical decision, by which property or rights are placed under the control of an administrator in order to administer them in the interest of one or several beneficiaries or with a specific purpose".[316]

The definition of a trust outlined above is also the definition used for purposes of the Belgium Income Tax Code of 1992 ("BITC")

Before one can understand how trusts are taxed in Belgium, one must have a basic overview of the taxation system in Belgium. Aside from some special provisions, trusts are largely taxed according to the general tax principles.

Belgium is a federal state. The tax base and the levying of the individual income tax are provided at federal level.[317] However, certain aspects of income tax are governed by regional provisions.[318] In addition, various surcharges and other taxes are imposed at a municipal or regional level.[319]

Under Belgium tax law, income is taxed according to different rules depending on the legal nature of the person who receives the income.[320] In broad terms, a taxpayer can be divided into one of the following categories:[321]

1. an individual;
2. a legal construct; or
3. a legal entity.

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[315] International Bar Association "Belgium International Estate Planning Guide" (2017) *Ibanet* <https://www.ibanet.org/internationalestateplanningguides.aspx> (accessed 22-01-2020).

[316] Article 122 of the International Private Law Act 2004.

[317] P Boone "Belgium – Individual taxes on personal income" (2022) *Tax Summaries* <https://taxsummaries.pwc.com/belgium/individual/taxes-on-personal-income> (accessed 18-02-2022).

[318] S van Crombrugge "De grondregels van het Belgisch fiscaal recht" (2014) *Biblio* <https://biblio.ugent.be/publication/5866313> (accessed 18-02-2022).

[319] Tax Foundation "Taxes in Belgium" (2022) <https://taxfoundation.org/country/belgium/> (accessed 18-02-2022).

[320] Tirard *The Global Guide to Trusts* 11.

[321] A Tiberghien *Handboek Voorfiscaal Recht 2016-2017* (2016).

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Regardless of the legal nature of the taxpayer, all taxpayers that are resident in Belgium are taxed, generally speaking, on their worldwide receipts and accruals, while non-resident taxpayers are typically only taxed on income from Belgium sources.[322] However, there are some exceptions to the above.[323] This means that a Belgium resident, which is a beneficiary of a non-resident trust, may be liable to tax on amounts distributed to it from the non-resident trust. However, this is subject to the Cayman tax, which is discussed in the next chapter.

As a point of departure, individual taxpayers are taxed at progressive rates, but special rates apply to specific types of income.[324] The tax brackets start at 25% and increase all the way to 50%.[325] This is in contrast to corporate income tax, which is largely levied at a fixed rate, subject to certain exceptions. The current corporate income tax rate is 25%, but in some cases can be reduced to as low as 20%.[326]

In the context of income tax, income can be divided into the following four categories of income:[327]

1. income from immovable property;
2. income from capital;
3. earned income; and
4. miscellaneous income.

In computing a person's income tax liability, the taxpayer's aggregated income across all the categories must be determined.[328] However, taxpayers are afforded a range of allowances, credits, exemptions and deductions that can be utilised to reduce the tax charge due.[329]

Generally speaking, in terms of Belgium taxation, the income tax treatment of

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[322] Tiberghien *Handbook Voorfiscaal Recht 2016-2017* (2016).
[323] JJ Couturier, B Peeters & E van Velde *Belgisch Belastingrecht in Hoofdlijnen* (2016) 35.
[324] Tax Foundation "Taxes in Belgium" (2022) *Tax Foundation* <https://taxfoundation.org/country/belgium/> (accessed 18-02-2022).
[325] KPMG "Belgium" (2021) *KPMG* <https://home.kpmg/xx/en/home/insights/2021/07/belgium-thinking-beyond-borders.html> (accessed 14-03-2022).
[326] P Boone "Corporate – Taxes on corporate income" (2022) *Tax Summaries* <https://taxsummaries.pwc.com/belgium/corporate/taxes-on-corporate-income> (accessed 11-03-2022).
[327] Couturier, Peeters & Van Velde *Belgisch Belastingrecht in Hoofdlijnen* 35-36.
[328] 46.
[329] 46.

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legal arrangements will be determined by their classification under civil law and their treatment under accounting law, except for special tax provisions. However, the classification assigned for tax purposes may differ from that under civil law.[330]

For tax purposes, a distinction is made between legal arrangements with legal personality and those without a separate legal personality.[331] If a legal arrangement is regarded to have legal personality under tax law and operates for gain, such entity will be subject to corporate income tax.[332] Those arrangements with legal personality and operating for a non-profit motive are not subject to corporate income tax but instead subject to a legal person's tax.[333]

Conversely, those arrangements without legal personality are regarded as fiscally transparent.[334] In such a case, the income is not taxed in the hands of the legal person but rather in the hands of the individual taxpayers. The concept of fiscal transparency can be further divided into full fiscal transparency and imperfect fiscal transparency. However, this distinction was much more relevant for trusts before the enactment of the Cayman tax regime.[335]

The notion of fiscal transparency refers to the phenomenon whereby a legal arrangement is disregarded for tax purposes so that the income obtained within the legal arrangement is attributed to the ultimate recipient of the income.[336] In a case of full fiscal transparency, the ultimate recipient of the income is placed in an identical tax position, to which the taxpayer would have been if the legal arrangement had never existed.[337]

It is possible that the existence of the legal arrangement nevertheless has a certain fiscal relevance. In particular, the fact that the income flows through the legal intermediary may alter the nature of the taxable income, even though the income is virtually immediately taxed in the hands of the ultimate recipient.[338] The latter case

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330 Tiberghien *Handbook voorfiscaal recht 2016-2017*.
331 Appermont et al *De Kaaimantaks: Panta rhei* 56.
332 GD Goyvaerts "The changes introduced by the Belgian look-through taxation regulations or Cayman 2.0" (2019) 25 *T&T* 202 231.
333 P Boone "Corporate – Taxes on corporate income" (2022) *Tax Summaries* <https://taxsummaries.pwc.com/belgium/corporate/taxes-on-corporate-income>.
334 Hefti (1956) *TAJoCL*556.
335 Goyvaerts (2019) *T&T* 206.
336 Tiberghien *Handbook Voorfiscaal Recht 2016-2017*.
337 Appermont et al *De Kaaimantaks: Panta rhei* 104.
338 Couturier, Peeters & Van Velde *Belgisch Belastingrecht in Hoofdlijnen* 47.

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may be described as imperfect fiscal transparency. Because foreign trusts do not have a separate legal personality, under Belgium tax law, these trusts are generally treated as fiscally transparent. However, the level of fiscal transparency is determined by the type of trust and the nature of the beneficiaries' right to the trust property as to determine the "level of intermediation" of the trust and to conclude whether the existence of the trust was relevant for Belgian tax purposes and thus led to either imperfect or perfect fiscal transparency.

In the absence of the application of the Cayman tax, various provisions of the BITC, in conjunction with basic tax principles, can be used to impose Belgium income tax on the parties to a trust.[339] Although, it should be stated that the success is subject to the specific facts and circumstances of the case.

Following from the former, it might be possible that the founder can be taxed on the foreign trust's income if the GAAR or the sham doctrine can successfully be invoked.[340] Alternatively, a resident beneficiary of a Bare trust or a fixed-interest trust may be subjected to Belgium income tax on the distributions. However, this is not the case for discretionary trusts. In such a case, the distributions to the resident beneficiaries are deemed to be tax free, but if the trustees of the foreign trusts are Belgium residents, the trustees may be liable for tax.

In light of the above, Belgium has no general tax regime for trusts, but the so-called Cayman tax regime is a form of a special anti-avoidance rule that regulates the taxation of foreign trusts in Belgium and which applies to almost all foreign trusts.[341] The specific workings of the Cayman tax regime are discussed in chapter 5.

However, it is worthwhile to note that the enactment of the Cayman tax regime did not repeal or override any of the general tax principles outlined above.[342] Instead, the Cayman tax was introduced as an autonomous system that operates alongside

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[339] K Moser "Trust and foundations in (Belgian) private wealth structuring, recent rulings" in C Docclo & J Malherbe (eds) *Alabaster 1938-2013* (2013) 589 590.

[340] GD Goyvaerts "The tax aspects of the use of foreign trusts in Belgium for private wealth purposes" (2011) 18 *JoIT&CP* 267 268.

[341] GD Goyvaerts "New Belgian CFC legislation for private wealth structures or Cayman tax" (2016) 23 *JoITT&CP* 25 28. P Maufort, "La taxe caïman : état des lieux" (2021) *Revue Générale du Contentieux Fiscal* 219 – 251. M Gossiaux, "La réception du trust en droit fiscal belge" (2020) *Revue de planification belge et internationale* 316 – 322. T Afschrift, "La taxation par transparence des revenus des 'constructions juridiques' (première partie)" (2016) *Journal de Droit Fiscal* 5 – 45. T Afschrift, "La taxation par transparence des revenus des 'constructions juridiques' (seconde partie)" (2016) *Journal de Droit Fiscal* 65–112.

[342] Goyvaerts (2019) *T&T* 234.

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previous Belgium tax principles. Notwithstanding the aforesaid, it is considered that the Cayman tax regime is the default tax regime applicable to trusts in Belgium.[343] However, because of the wide scope of the Cayman tax, there are almost no cases where foreign trusts are still taxed in accordance with the general tax principles in Belgium.

Aside from the brief overview provided above, the taxation of the trust parties in terms of the principles alluded to above is not discussed further. Instead, the ambit of the dissertation is limited to the Cayman tax regime, as this regime regulates the taxation system of almost all trusts the Belgian legal system encounters.

The Cayman tax regime can be described as a regime of fiscal transparency that disregards the use of foreign legal structures by resident Belgium taxpayers.[344] By virtue of the Cayman tax, the income that accrues to or that is received by such legal arrangements is deemed to have been received by the resident founders directly and taxed accordingly.[345] Aside from the notion of fiscal transparency, the regime introduces various fiscal fictions, a range of attribution rules and specific anti-avoidance rules.[346] In certain respects, the Cayman tax is reminiscent of a Controlled Foreign Corporation ("CFC") regime.

If a legal arrangement falls within the ambit of the Cayman tax, the founder of said arrangement will be the taxable party by default.[347] The ambit of the Cayman tax extends beyond mere trusts, but trusts form an important component of the regime.[348] If a foreign trust has a Belgium resident founder, the income that is accumulated in the trust is deemed to be the income of the founder and taxed in the hands of the founder.[349] In such a case, the foreign trust's income is taxed according to the individual income tax rules. Due to the transparent nature of the Cayman tax regime, the income will keep its "fiscal identity" (for example, immovable income or movable income) when deemed to be that of the resident founder. This means that the founder will be afforded all the benefits that they would have been entitled to if the founder

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343 Appermont et al *De Kaaimantaks: Panta rhei* 108.
344 S Lust "The Belgian 'Cayman tax' and its impact on wealth and estate planning in Belgium" (2018) 24 *T&T* 230 231.
345 Goyvaerts (2019) *T&T* 234.
346 Appermont et al *De Kaaimantaks: panta rhei* 110.
347 Goyvaerts (2019) *T&T* 222.
348 Lust (2018) *T&T* 230 233.
349 Appermont et al *De Kaaimantaks: Panta rhei* 108.

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received the income directly and not by the foreign trust.

However, if the foreign trust distributes the income received to the founder, such distribution will be deemed to be a dividend, and the founder will be taxed accordingly.[350] Consequently, the distributed income will lose its identity and will be treated as a dividend. Under certain circumstances, the founder will not be taxed if the income was distributed to a third-party beneficiary, but it remains the founder that is primarily responsible for settling the tax charge.[351]

In addition, the Cayman tax regime has introduced a range of record-keeping and sometimes burdensome reporting requirements.[352] Amongst other obligations, all founders and beneficiaries of foreign trusts must disclose their interests to the General Fiscal Administration ("GFA") in their annual tax returns.[353]

Based on the aforementioned, if the Cayman tax regime applies, Belgium mainly taxes the founder of the trust on all the trust's income. This indicates that Belgium subscribes to option A[354] under the second classification method. However, in those (very rare) instances that the Caman tax regime does not apply, it appears that Belgium uses a combination of systems depending on the specific circumstances. Notwithstanding the aforesaid, it does appear that Belgium subscribes to the policy stance that trust income should only once be subjected to taxation throughout the trust relationship.

4 5 2 Determining residence status

Under Belgium tax law, a person's tax obligations are determined according to their residency status.[355] The concept is not just relevant for assigning a taxing right to Belgium but also to ascertain the extent of taxation. Belgium follows a residency-based taxation system, which means that Belgium residents are generally taxed on worldwide income. Conversely, non-residents are typically only liable to tax on

[350] Goyvaerts (2019) *T&T* 222.
[351] Appermont et al *De Kaaimantaks: Panta rhei* 110.
[352] GD Goyvaerts "Belgium: A new obligation to declare foreign private wealth structures" (2014) 21 *JoITT&CP* 64 65.
[353] 67.
[354] See paragraph 4.2 p 196.
[355] S van Crombrugge "De grondregels van het Belgisch fiscaal recht" (2014) *Biblio* <https://biblio.ugent.be/publication/5866313> (accessed 18-02-2022).

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Belgium source income.[356] For this reason, it is not surprising that one's residency status can have substantial consequences.

In determining a taxpayer's residency status, the BITC distinguishes between natural persons, such as individuals, and legal persons, such as companies, with regard to the test that must be applied.[357] However, in line with the rules pertaining to the classification of taxable persons, there is no provision made for legal arrangements without a separate legal personality. Hence, for such fiscally transparent entities such as trusts, one must look to the underlying parties to the trust for such determination unless a specific tax regime – such as the Cayman tax – applies.

In the case of individuals, a person will be regarded as a resident for tax purposes if they are ordinarily resident in Belgium or put differently, if they are domiciled in Belgium.[358] Alternatively, if the individual's domicile is outside Belgium, the individual will only be considered a tax resident if their centre of economic interests ("COEI") is located in Belgium.[359]

The question of residency is a complex notion and, in most cases, a factual matter that must be decided by weighing up the different components.[360] However, there is no single decisive factor, but rather all circumstances must be considered. In this determination, the centre of a person's family life is of greater importance than the place where that person factually resides or where they exercise their profession.[361]

The Belgian Supreme Court has held that the concept of domicile refers to the factual place of residence, the centre of a person's social and professional interests, and is necessarily characterised by a certain degree of permanence or continuity.[362]

The term COEI or also referred to as a person's seat of wealth can be described as the location from where the person's property is administered, regardless of where the property is actually situated.[363]

Although an individual's residence or COEI is determined based on factual circumstances, there is a rebuttable presumption that a person who is registered in

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356 Couturier, Peeters & Van Velde *Belgisch Belastingrecht in Hoofdlijnen* 47-49.
357 Tiberghien *Handbook voorfiscaal recht 2016-2017*.
358 *Code des impôts sur les revenus* 1992 art 2, s 1 1°.
359 *Code des impôts sur les revenus* 1992 art 2, s 1 1°.
360 Boone "Belgium – Individual taxes on personal income" (2022) *Tax Sumamries*.
361 A Bellens "Chapter 12: Belgium" in G Maisto (ed) *Residence of Individuals under Tax Treaties and EC Law* (2009) 277 279.
362 Supreme Court 15 November 1990, F.J.F. 1991, 70.
363 Supreme Court 7 February 1979, Bull. Contr./Bull. Bel. No. 611, 2713.

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the civil register of a Belgian municipality is deemed to be a resident. To this extent, all individuals who stay longer than three months in Belgium are required to register with the population register, which triggers the deemed tax residency.[364] Furthermore, a person who is married is deemed to be a resident in the place in which their family is established.

Conversely, where legal persons are concerned, a company will be regarded as a Belgium resident for tax purposes if it either has its legal seat, permanent establishment or POEM within the Kingdom of Belgium.[365]

If a company has its legal seat in Belgium, it is assumed to also have its permanent establishment or POEM in Belgium.[366] However, this assumption is refutable if the company can establish that it is tax resident in another state according to that state's tax legislation. The legal seat of a company, or put differently, the registered office of a company, can be defined as the company's official address as included in the articles of association and as mentioned in the registration at the Companies Register.[367]

In terms of Belgium law, if a company's registered office is located in Belgium, that company's legal seat is also considered to be in Belgium.[368] Normally, this will coincide with the company's place of incorporation, but not necessarily. The company in question is regarded as a Belgium tax resident in such a case. If the aforesaid applies, it is the end of the enquiry, and it is not necessary to consider the other criteria. Otherwise, if the company's legal seat is located outside Belgium, one must proceed with the other tests.

Aside from the above, it is also possible for a company to be classified as a Belgium tax resident on the basis of a permanent establishment.[369] Undeniably, the notion of permanent establishment is not without controversy, but the complex nature is widely recognised. Although a detailed discussion of the concept is outside the ambit of this dissertation, in order to provide context to the problem at hand, it is worthwhile to briefly mention some of the important aspects.

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[364] Bellens "Chapter 12: Belgium" in *Residence of Individuals under Tax Treaties and EC Law* 279-280.
[365] *Code des impôts sur les revenus* 1992 art 2, s 1 5°(b).
[366] Article 2, s 1 5°.
[367] N Bammens & F Henneaux "Chapter 7: Belgium" in E Traversa (ed) *Corporate Tax Residence and Mobility* (2018) 187 192.
[368] 192.
[369] KPMG "Belgium" (2021) *KPMG*.

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In broad terms, the concept of permanent establishment refers to the extent of the business activities that are conducted in that country.[370] If it is determined that a reasonable level of activities are taking place, it is likely that a permanent establishment exists. However, there must also be an element of permanency to the operations. In such a case, the existence of a permanent establishment in Belgium means that the company has a taxable presence. In other words, the permanent establishment constitutes a sufficient link between the foreign company and Belgium in order for Belgium to regard the company as a tax resident.

Belgium largely follows the OECD's definition of permanent establishment as contained in the 2017 Model Tax Convention on Income and Capital ("MTC"). Accordingly, article 5(1) of the MTC provides that a permanent establishment means "a fixed place of business through which the business of an enterprise is wholly or partly carried on".[371]

In terms of the OECD Model Tax Convention Commentary, there must be a fixed place of business, in that there must be a degree of permanence to such place of business, and the place of business must be at the disposal of the enterprise.[372] Naturally, business activities must be conducted at the fixed place of business, which can be partly or wholly carried on. Typically, permanence would mean a period of business for more than six months, although the Commentary does clarify that there is no set rule for a time period to indicate permanency, and the facts and circumstances of each case must be considered.[373]

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[370] Bammens & Henneaux "Chapter 7: Belgium" in *Corporate Tax Residence and Mobility* 199.
[371] OECD "Model Tax Convention on Income and on Capital 2017" (2017) *OECD* <https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page1> (accessed 16-03-2022); art 5(1) of the 2017 Model Tax Convention on Income and Capital.
[372] OECD "Commentaries on the Articles of the Model Tax Convention" (2010) *OECD* <https://www.oecd.org/berlin/publikationen/43324465.pdf> (accessed 15-03-2022).
[373] OECD "Commentaries on the Articles of the Model Tax Convention" (2010) *OECD*.

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In addition, articles 5(2) and 5(3) of the MTC outline a number of examples of activities that will constitute permanent establishments,[374] while article 5(4) lists a few deemed exclusions to the concept of a permanent establishment.[375]

Furthermore, a company will be regarded as a Belgium resident for tax purposes if the company has its POEM in Belgium. Defined as the place where corporate decision making, effective management, and central administration take place.[376]

The concept of POEM can be described as the place where a company's officers coordinate, direct, and control the company's activities. This can coincide with the company's registered office or headquarters, so long as it is the centre of coordination, direction, and control of the company and not merely the place where board meetings are held.[377]

The term seat of management, otherwise known as the POEM, has been defined by Belgian case law as the place from where directing impulsions emanate or the place where the company's effective management and central administration abide, meaning the place where the corporate decision-making process actually takes place.[378]

Although a company may have numerous places of management, it can only have one POEM at any point in time.[379] The determination of a company's POEM is a factual enquiry.[380] In essence, it boils down to where key management and commercial decisions necessary for the company's operations as a whole are made. If that is from a Belgian office, that company is considered a Belgian tax resident under Belgian law.

To determine a trust's tax residency, one has to look to the residency status of the trustees of the trust. In terms of trite trust principles, both natural persons and legal

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374 OECD "Model Tax Convention on Income and on Capital 2017" (2017) *OECD* <https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page1> (accessed 16-03-2022); art 5(2) and (3) of the 2017 Model Tax Convention on Income and Capital.

375 OECD "Model Tax Convention on Income and on Capital 2017" (2017) *OECD* <https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page1> (accessed 16-03-2022); art 5(4) of the 2017 Model Tax Convention on Income and Capital.

376 Bammens & Henneaux "Chapter 7: Belgium" in *Corporate Tax Residence and Mobility* 192.

377 Boone "Corporate – Taxes on corporate income" (2022) *Tax Summaries*.

378 Bammens & Henneaux "Chapter 7: Belgium" in *Corporate Tax Residence and Mobility* 192.

379 S van Crombrugge "De grondregels van het Belgisch fiscal recht" (2014) *Biblio* https://biblio.ugent.be/publication/5866313 (accessed 18-02-2022).

380 Van Crombrugge "De grondregels van het Belgisch fiscaal recht" (2014) *Biblio*.

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persons can be a trustee of a trust. To this extent, depending on the type of trustee, one would have to apply the relevant test. However, since the entry into force of the Cayman tax, the tax residency status has become less important within the framework of the taxation of foreign trusts in Belgium. However, in cases where the trust does not have founders or beneficiaries who are tax resident in Belgium, and the Cayman tax does not apply, a trustee who is tax resident in Belgium can still be taxed on the income of the trust which that trustee administers. Because such a trust does not have legal personality and is therefore not regarded as a separate taxable entity under Belgian law, the trustee is taxed on all the trust income.

In addition to the above, since Belgium does not have a domestic trust regime, the notion of a Belgium trust does not exist.[381] The only option for a Belgium resident who would like to use a trust would be to establish a foreign one. However, if the founder is a Belgium resident, the trust would fall within the ambit of the Cayman tax regime and would be taxed accordingly.

The founder of the foreign trust can elect the jurisdiction's law that will apply to the trust. Typically, this would be outlined in the trust deed. In most cases, the founder will choose the law in terms of which the trust is formed, but it is not a requirement.[382]

If one considers the Belgium tax framework and the fact that the trust concept is not assumed into Belgium law, it is unlikely that a Belgium resident will deliberately create a foreign trust that is governed by Belgium law. Notwithstanding, if a Belgium resident is a trustee of a foreign trust, or if the trust's assets are situated in Belgium, it may be possible that Belgium law will apply to certain aspects of the trust, pursuant to the application of Belgium's rules of private international law, for example, with regard to property law aspects.[383]

4 5 3 The Belgian GAAR

Based on the constitutional principle of legality, no tax can be introduced for the benefit of the State except by law.[384] From this principle, it can be deduced that, among other

[381] Goyvaerts (2011) *JoIT&CP* 270.
[382] Hefti (1956) *TAJoCL* 558.
[383] N Appermont *De Trust. Een juridisch Kader Voor De (Internationaal) Privaatrechtelijke Inpassing en Fiscal Gevolgen* (2017) 591 ff.
[384] B Peeters "Hetfiscaal legaliteitsbeginsel in deBelgischeGrondwet: verstrakking oferosie?" in B Peeters & J Velaers (eds) *De Grondwet in Groothoekperspec- Tief. Liber Amicorum Discipulorumque Karel Rimanque* (2007) 512.

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things, everything is free of tax unless the law that is the sole source of taxation provides otherwise.[385] This constitutional rule also explains why tax laws in Belgium are, in principle, strictly interpreted. Consequently, if a taxpayer remains outside the scope of application of a tax law, said taxpayer cannot, in principle, be subjected to the tax provided for by said law.[386] Otherwise, in violation of the Constitution, the tax law in question would be applied to a situation not intended by it.

The principle of tax legality also forms the basis of the doctrine of the free choice of the least taxed path developed in Belgian case law.[387] The right of citizens to take the least taxed path and thus avoid taxes was first articulated by the Court of Cassation in the famous *Belgium vs SA Etablissements Brepols* judgment.[388] According to the Court of Cassation, there is no prohibited simulation *vis-a-vis* the tax authorities, and therefore no tax fraud, when the parties make use of their freedom of contract and perform legal acts of which they accept all the consequences, even if the form they give to those legal acts is not the most normal one, with the intention of enjoying a more advantageous tax regime.[389] The Court has since reaffirmed this position on several occasions.[390]

However, the right of citizens to follow the least taxed path is not absolute but is limited by a number of preconditions and constraints, which must be observed if their tax avoidance behaviour is to be successful.[391] But, a discussion of these aspects falls outside the ambit of this dissertation and hence, will not be discussed.

Notwithstanding the above, the administration has in the past made several propositions that, if successful, would have led to this freedom of choice principle being curbed. However, the Supreme Court systematically rejected the administration's propositions in some key judgments. The main developments can briefly be summarised as follows:[392]

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[385] N Appermont "De verhouding tussen het burgerlijk recht en het fiscaal recht in de Belgische rechtsorde" (2018) *Algemeen Fiscaal Tijdschrift* 27.
[386] B Peeters "De algemene fiscale antimisbruikbepalingen. Een commentaar in het licht van de rechtspraak van het Grondwettelijk Hof" (2014) *Algemeen Fiscaal Tijdschrift* 5.
[387] Couturier, Peeters & Van Velde *Belgisch Belastingrecht in Hoofdlijnen*.
[388] *Belgium vs SA Etablissements Brepols*, June 1961, Court Cassation.
[389] *Belgium vs SA Etablissements Brepols*, June 1961, Court Cassation.
[390] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 5.
[391] L de Broe & J Bossuyt "Interpretatie en toepassing van de algemene antimisbruikbepaling in inkomstenbelasting, registratie- en successierechten" (2012) 11 *Algemeen Fiscaal Tijdschrift* 7.
[392] P Peeters (2014) *Algemeen Fiscaal Tijdschrift* 9.

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1. rejection of the tax law evasion theory; and
2. rejection of the economic reality theory.

In light of the tax administration's failed attempts to restrict the effect of the free choice doctrine and to address the shortcomings of the GAAR, the process was initiated to enact a new GAAR.[393]

According to the explanatory memorandum, the text should enable the administration to tackle legal abuse efficiently without fundamentally altering legal certainty and the principle of free choice of the least taxed path.[394] The main purpose of the GAAR is to eliminate two current forms of tax avoidance through legal design, namely:[395]

1. the choice of a legal form to place oneself in a situation that does not meet the legal conditions to be taxable but which is very close to the taxable situation when there is no other substantial explanation for that choice than tax savings. The intention of the legislator would be violated if the tax law is not applied to the alleged legal act;
2. enforcing an advantageous law: the legal form of choice to bring oneself under a standard that provides a tax advantage when there is no substantial explanation for that choice other than tax savings. The claim to this benefit runs counter to the intention of the law.

However, the use of the GAAR has further been described as an ultimate weapon and should only be applied by the administration when the ordinary method of interpretation, the technical provisions of the Code, the special anti-avoidance provisions and the simulation doctrine are inadequate.[396] Thus, it should not be construed as being the default position.

As a point of departure, the application of the new general anti-abuse tax provisions is subject to various conditions and modalities. Thus, they can only be invoked under very specific circumstances.[397] First, it is required that a legal act or a

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[393] The old Belgium GAAR was replaced in 2012.
[394] De Broe & Bossuyt (2012) *Algemeen Fiscaal Tijdschrift* 7.
[395] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 9.
[396] Appermont (2018) *Algemeen Fiscaal Tijdschrift* 31.
[397] *Code des impôts sur les revenus* 1992 art 344 s 1.

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set of legal acts bringing about the same transaction have been performed with the intention of escaping tax. Next, this tax avoidance intention must qualify as tax abuse. Finally, the provision provides how the taxpayer's tax situation in case of proven tax abuse must be reviewed. In such a case, the abuse must be remedied by subjecting the transaction or the set of transactions to tax in accordance with the purpose of the law as if the abuse had not occurred.

The concept of “transaction” is not defined, but according to the explanatory memorandum, the provision applies both to transactions performed within the framework of the management of private assets and to transactions performed in the economic sphere.[398]

Thus, the first requirement is that there must be a legal act. Such a legal act can be comprised of one or more parts. However, the set of legal acts must relate to the specific transaction. Put differently, a set of legal acts bringing about the same transaction is said to exist if a transaction is artificially divided into successive acts covering one assessment year or longer. This means that such classification is not only limited to parts of a transaction that falls within one year of assessment. Thus, if the acts are spread over a number of years, the administration will nevertheless be able to apply the GAAR if it demonstrates the unity of intention between the acts. To this end, the successive acts must be a series of acts conceived from the outset as belonging to an indivisible chain.

Following from the above, one can derive two requirements for such classification: [399]

1. premeditated intention; and
2. artificial division.

The first condition implies that the mere tax benefit of the transaction without the premeditation is insufficient. The second requirement implies that at least in the totality of the transaction, there must be one or more acts that have no meaning except to avoid tax. Hence, the requirement of indivisibility is closely related to the premeditation requirement. It boils down to the fact that before doing the first legal act, the taxpayer already has a clear intention to realise the subsequent acts. This means that if the

[398] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 9.
[399] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 11.

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administration succeeds in proving this unity of intention between successive legal acts, it can potentially apply the GAAR to the various legal acts regardless of the period in which it was performed.

Once it has been established that a legal act intending to avoid tax is present, the second requirement is to determine whether the avoidance intention constitutes tax abuse.[400] For such determination, the definition of tax abuse can be divided into the following components: [401]

1. objective; and
2. subjective.

The objective element implies that the taxpayer chooses a legal act or a set of legal acts that allow said taxpayer to place himself in a situation that is contrary to the objectives of a provision of the BITC.[402] However, the burden of proof for the objective element rests entirely on the administration.[403] The administration may use all means of proof to discharge the onus.

According to the court, the conflict with the objectives of the specific tax provision must be understood in the light of the concept of wholly artificial construction.[404] In this regard, the Constitutional Court[405] has also stated that it is required that the effect of the transaction is to escape taxation, either by enjoying a tax advantage or by placing oneself outside the scope of a tax provision.[406] Thus, the effect of the transaction described must be contrary to the objectives pursued by the tax provision in question and not merely extraneous to such objectives.

The court further held that the administration could only establish this conflict if the provision's objectives were sufficiently clear from the text and, where appropriate, from the parliamentary preparation of the applicable legal provision.[407]

Moreover, in this determination, the administration must take into account, *inter alia*, the general context of the relevant tax legislation, the practices normally prevailing

[400] *Code des impôts sur les revenus* 1992 art 344 s 1.
[401] De Broe & Bossuyt (2012) *Algemeen Fiscaal Tijdschrift* 10.
[402] *Code des impôts sur les revenus* 1992 art 344 s 1.
[403] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 11.
[404] De Broe & Bossuyt (2012) *Algemeen Fiscaal Tijdschrift* 12.
[405] Constitutional Court of Belgium, Case 141/2013 of 30 October 2013, B.21.1.
[406] 12.
[407] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 11.

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at the time of entry into force of the tax provision whose abuse it alleges, as well as the possible existence of specific provisions already aimed at counteracting certain abusive transactions.[408]

The subjective element implies that the taxpayer chooses the relevant legal act, or set of legal acts, for the sole purpose of obtaining a tax benefit.[409] Consequently, there can only be tax abuse if the taxpayer himself performed the tax-avoiding legal act. In other words, the tax administration cannot act against a taxpayer who did not carry out the disputed legal act himself, even if he is the final beneficiary of its tax-avoiding effect.

On the subjective element, the Constitutional Court[410] further held that to be classified as tax abuse, the operation must be motivated solely by the concern to avoid tax or be so essential that any other objectives of the operation must be regarded as negligible or purely artificial, not only in economic terms but also in the light of other relevant considerations. [411]

According to the explanatory memorandum, the subjective element means that the taxpayer chooses this legal act or set of legal acts with the essential aim of obtaining the tax benefit.[412] However, the administration does not have to prove that the choice of form was determined solely by tax motives. This would amount to an impossible burden of proof for the administration, but instead, that one of the taxpayer's motives was to avoid tax.

Only after the administration has presented its case does it fall to the taxpayer to demonstrate that his choice of the disputed transaction was justified by motives other than avoiding tax.[413] However, these other objectives must not be regarded as negligible or purely artificial. This means that if the non-tax motives fall into one of the following categories, the onus will not be discharged:[414]

1. legal acts in which the non-fiscal motifs are in nothing specific to the operation in question but, on the contrary, are so general that they are necessarily present in any operation of the same type;

[408] Couturier, Peeters & Van Velde *Belgisch Belastingrecht in Hoofdlijnen*.
[409] *Code des impôts sur les revenus* 1992 art 344 s 1.
[410] Constitutional Court of Belgium, Case 141/2013 of 30 October 2013, B.21.1.
[411] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 11.
[412] De Broe & Bossuyt (2012) *Algemeen Fiscaal Tijdschrift* 14.
[413] *Code des impôts sur les revenus* 1992 art 344 s 1.
[414] De Broe & Bossuyt (2012) *Algemeen Fiscaal Tijdschrift* 14.

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2. legal acts where the non-fiscal motives, although specific to the operation in question, are of such limited importance that a reasonable person would not carry out the operation because of the non-fiscal motive.

This rebuttal opportunity allows the taxpayer to demonstrate that any possible tax savings were not the exclusive or essential motive for the transaction. Thus, it is acceptable that one of the taxpayer's motives for the transaction was tax considerations, as long as it was not the exclusive motive. However, the tax abuse is proven if the administration can prove the tax motive and the taxpayer cannot subsequently provide the required counter evidence.

In cases of proven tax abuse, the administration must rectify such abuse.[415] In short, this means that in the event of proven tax abuse by a taxpayer, the administration must apply the tax provisions as if the abuse had not taken place. To achieve this goal, the alleged legal transaction or the whole of legal transactions bringing about the same transaction from a tax point of view will be re-examined by the administration. This can result in either the transaction being disregarded or that it is converted or requalified.

Ultimately, by invoking the GAAR, the circumvented legal provision will be applied as if the tax abuse never took place. But, if the application of the anti-abuse provisions goes beyond the mere disregard of a legal act and leads to a conversion or requalification, the administration will have to respect the direction that was created by the legal acts.[416]

However, it should be stressed that the re-examination of the tax situation has no bearing whatsoever on the civil law consequences of the legal transactions, which are otherwise unaffected.[417]

4 6 Comparison of jurisdictions

Based on the preceding discussion, it is evident that the income tax treatment of trusts differs substantially among jurisdictions. These vast differences can largely be

[415] *Code des impôts sur les revenus* 1992 art 344 s 1.
[416] Couturier, Peeters & Van Velde *Belgisch Belastingrecht in Hoofdlijnen*.
[417] Peeters (2014) *Algemeen Fiscaal Tijdschrift* 15.

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attributed to the diverse policy positions and the way in which the policy choices interact within the greater legal system.

Although all three main jurisdictions tax trust income in distinct ways, the underlying principles are similar. From a policy perspective, various methods have emerged to tax trusts. The first classification focuses on the mechanism used, while the second focuses on the person who is to be taxed within the trust relationship, and the third classification focuses on the treatment of the trust entity as a whole. Countries can elect to either apply one of these systems or rather use a combination of the aforesaid.

South Africa primarily applies an initial choice system for the taxation of trusts. The UK mainly uses the credit system. Conversely, Belgium largely subscribes to option A[418] under the second classification method. However, all three jurisdictions also view the trust structure as a hybrid flow-through entity. Aside from the aforementioned methods, all the jurisdictions further apply a combination of systems depending on the facts and circumstances of the case. Notwithstanding the mechanisms used, all three jurisdictions adhere to the principle that trust income must only be subjected to tax once throughout the trust relationship. It is submitted that the South African approach strikes the best balance between simplicity and fairness.

In all three jurisdictions, trusts are not regarded as juristic entities, nor do trusts have separate legal personality. However, in South Africa, trusts are classified as separate taxpayers, but the trust cannot act by itself. Instead, the trustees act on behalf of the trust. While in the UK, it is not the trust itself that is regarded as the taxpayer, but the body of trustees is considered to be a separate taxpayer. In South Africa, the trustees are the representative taxpayers of the trust. In the UK, for tax purposes, the trustees of a settlement are treated as if they were a single person, distinct from the persons who may, from time to time, be trustees of said trust. This is in contrast with Belgium, where the trust is not treated as a taxable person, but its existence is taken into account for tax purposes.

In both South Africa and the UK, the trustees can be held personally liable for the trust's tax obligations under certain conditions. In general, the trustees have a duty to represent the trust in all matters relating to taxation.

[418] See paragraph 4.2 p 196.

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Under UK law, there are different rules and applicable tax rates for different types of trusts and different types of income. Aside from the £1000 exemption, discretionary trusts are taxed at the highest rates. For dividend income, the tax rate is 38,1%, and all other income is taxed at 45%. Fixed or an interest in possession trusts are taxed at the basic rate, regardless of the amount of income received. The basic rates are 7,5% for dividend income and 20% for other income. Bare trusts are taxed according to the progressive sliding scale that is applicable to individuals. The current tax bands range from 20% to 45%. Both the UK and South Africa make provision for so-called trusts for vulnerable beneficiaries or special trusts, which are afforded favourable tax treatment if all the criteria are met. In South Africa, with the exception except for trusts that fall under a specific tax regime, all trusts are taxed at a marginal rate of 45%, regardless of the trust type or the type of income received. For vested trusts or if income is not accumulated in the discretionary trust, but rather distributed to the beneficiaries, the income will be taxed in the hands of the beneficiaries according to the tax bands for individuals. The sliding scale ranges between 18% and 45%. In the case of Belgium, undistributed trust income is taxed in the founder's hands, according to the individual tax rates. The tax brackets start at 25% and increase all the way to 50%. All distributions from the trust to beneficiaries and to the founder of a trust are normally regarded as dividends and taxed at the dividend rate, which is currently 30%.

In light of the above, it is interesting to observe that all three jurisdictions tax trusts at marginal rates. Naturally, there are some exceptions, but the aforesaid applies under most circumstances. It is submitted that one possible reason for the detrimental tax treatment of trusts is the perception in the tax arena that the trust concept has become synonymous with tax avoidance and other devious activities.

In both South Africa and the UK, there is no personal rebate available for trusts. Similarly, a trust does not qualify for the exemptions and tax-free allowances offered to natural persons. In the case of the UK, beneficiaries of a fixed or an interest in possession trust can utilise some of these allowances, depending on their income band and personal circumstances. However, in both jurisdictions, the trustees are permitted to claim deductions for which the trust qualifies. Conversely, in Belgium, the founder can utilise all benefits available to natural persons if the Cayman tax applies because of its transparent approach.

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Unlike South Africa and Belgium, the UK has introduced a trust registry. All UK trusts, which have some form of tax liability in the UK, are obligated to register. The trust register contains information in relation to the trust, the trustees, the beneficial owners (the settlor and beneficiaries) and the trust assets. In the case of South Africa, aside from the information contained in the trust's tax returns, the only other disclosure requirement is the requirement that all trust deeds must be lodged with the Master of the Court. In the case of Belgium, the GFA requires the trust parties to disclose the existence of the trust and various other trust information in their tax returns. Furthermore, Belgian residents who are involved with a trust should be registered in the registry of Ultimate Beneficial Owners.

In contrast to South Africa and Belgium, the UK uses both a person's residency status and domicile as determinants for levying taxes. In the case of the former jurisdictions, only residency is used for assigning a taxing right. For this reason, it is crucial to understand these concepts and their effect on one's personal circumstances.

All three jurisdictions use a residency-based taxation system. This means that generally speaking, all the jurisdictions tax their residents on their worldwide receipts and accruals, while non-residents are normally not subject to taxation in that jurisdiction on any foreign receipts and accruals but are only liable to taxation on income that is from a source within that jurisdiction. This means that for all jurisdictions, the point of departure is that the parties in the trust relationship will also be taxed according to the general rule as outlined above. However, there are exceptions to the aforesaid.

In all the jurisdictions, the test for determining a person's residency status depends on the type of person they are considered to be for tax purposes. The UK, South Africa and Belgium broadly distinguish between natural persons and legal persons. In the case of South Africa, the ITA does not refer to legal persons but rather adopts the wider phrase persons other than natural persons. Conversely, in the UK and Belgium, the legal person category is limited to those entities with separate legal personality. However, none of the jurisdictions has a specific test for so-called opaque entities such as trusts. In the case of the UK and Belgium, one rather looks to the underlining parties to establish residency status. In South Africa, the phrase persons other than natural persons encapsulates trusts. Hence, the same test will apply to trusts.

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For determining an individual's residency status, all three jurisdictions will consider all facts and circumstances of each case. Throughout the process, the tests aim to establish a sufficient physical link to the jurisdiction. Although the jurisdictions apply different tests, the enquiry revolves around being physically present in the country for a certain period for that year of assessment or having adequate ties to the jurisdiction or a combination of the aforesaid factors.

Conversely, where legal persons are concerned, all the jurisdictions regard entities that are incorporated in their jurisdiction as a resident for tax purposes. To this extent, Belgium does not refer to the incorporation of an entity but rather uses the wider term of the legal seat. In the alternative, South Africa and Belgium also treat entities with their POEM in their jurisdictions as tax residents.. In the case of the UK, the alternative to being incorporated in the UK is if the entity's place of CMAC is located in the UK. It is submitted that despite the different terminology used, the concept of CMAC is very similar to the notion of POEM that is used in South Africa and Belgium.

Unlike in South Africa, in both the UK and Belgium, it is not the trust or the settlement that is resident for tax purposes but rather the trustees. To determine the trust's residency status, one needs to ascertain the residency status of the trustees and the settlor. In the case of Belgium, the residency status of the founder is much more important than that of the trustees. If the founder of the trust is a Belgium resident, the Cayman tax regime will apply, and for all intended purposes, the trust will be treated as a tax resident in Belgium. The trust is resident in South Africa if it has been formed in South Africa or if it has it is POEM in South Africa. It is submitted that the UK's approach is preferred over that of the other jurisdictions, but it is recommended that a specific test is developed for trusts.

In contrast to South Africa, the UK has not adopted the conduit pipe principle into their law. If the trustees exercise their discretion in favour of the beneficiary, the income distributed by the discretionary trust to the beneficiary loses the income's original source, and from there on, the trust is regarded as the source of the income. However, if trustees of a fixed or an interest in possession trust pass income on to the beneficiaries, such income will retain its original character in the hands of the beneficiaries. Since Belgium does not have a domestic trust law, the conduit pipe principle does not exist. Notwithstanding the aforementioned, the Cayman tax regime operates on a fully transparent fiscal basis. It is submitted that the Cayman tax regime

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implements a form of a quasi-conduit pipe principle. It is further submitted that the notion of the conduit pipe principle forms a fundamental part of the trust structure and should be retained.

Under UK law, in order to prevent income from slipping through the tax net, the tax system operates to ensure that all possible taxes due are collected at a trustee level. As such, trustees are liable to tax on all the income due to the trust, whether or not the trustees receive it. This is in contrast to South Africa, where even though the trustee is the representative taxpayer of the trust, it is not necessarily the trustees that are assessed. Conversely, in Belgium, the trust's founder is the party that remains principally liable for all taxes due on the income received by or that accrues to the trust.

In terms of South African law, the trust is only taxed on the trust’s income if the income is accumulated in the trust and not distributed to beneficiaries in the year of assessment. If a distribution is made in a later tax year, the distribution will no longer be of an income nature but rather capital. This is in contrast to the UK, where the trustees are always taxed on the income received unless the trustees of a **fixed or interest** in possession trust mandate income directly to a beneficiary. If the trustees distribute income to beneficiaries in the year of assessment, the trustees are further taxed on said distribution. In the case of Belgium, the trustees are only potentially liable to tax if the Cayman tax regime does not apply. In such a case, the trustees can be taxed on the trust’s income.

In South Africa, beneficiaries are only liable to tax on trust income if the trustees distribute said income to the beneficiaries in the year in which it was received or accrued. In such a case, the normal income tax rates, as determined by the sliding scale for individuals, are applicable. This can be compared to the position in the UK, where the beneficiaries of a discretionary trust will have no tax liability unless the beneficiary is an additional rate taxpayer. In all other cases, the beneficiaries may be able to claim a tax rebate for the difference between the taxes paid by the trustees when making the distribution and the beneficiaries’ actual tax liability. However, where fixed or interest in possession trusts are concerned, the *ultimate* income tax liability will be determined by the recipient beneficiary’s personal tax position. Only if the beneficiary is a basic rate taxpayer will there be no further tax liability for the beneficiary. If the trustees mandated income directly to the beneficiary, the trustees

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have no income tax liability, and the beneficiary is simply taxed directly in relation to the income received. In the case of Belgium, the beneficiaries' tax liability is only relevant if the Cayman tax regime does not apply. Otherwise, the founder will be liable for the taxes due, even if distributions are made to the beneficiaries.

In all three jurisdictions, it is also possible that the trust’s income is taxed in the hands of the founder or settlor of the trust. Even though the income was not received by nor accrued to the founder or settlor, in both South Africa and the UK, the founder or settlor is not usually taxed on trust income unless one of the anti-avoidance provisions applies. In the case of Belgium, the default position is that the founder is taxed on the trust income if the trust falls within the ambit of the Cayman tax regime, but the Cayman tax regime can be described as a special anti-avoidance rule. In all jurisdictions, depending on the anti-avoidance provision, the founder or settlor may have a right of recovery against the party that actually received said income. Similarly, the extent and duration of the subsequent tax liability can differ among the various provisions.

In conclusion, it is clear that there is no “one size fits all” approach to trust taxation. Ultimately, the approach adopted will depend on factors such as the jurisdiction’s perceptions toward trusts, wider policy position and the underlying legal system. Broadly speaking, regardless of the method used, the end result is similar. However, the level of complexity differs vastly among the various options. Despite the differences between the three jurisdictions, there are also many similarities.

It is noteworthy that all the jurisdictions subscribe to the policy stance that trust income should only be subject to tax once throughout the trust relationship. Furthermore, the classification of residents is comparable; even though the terminologies and tests differ, the underlying fundamental principles are nevertheless the same. Similarly, a GAAR may be applied to transactions involving trusts in each of the jurisdictions. Although the GAARs are worded differently, there are also many parallels between them, for example, that purpose of the transaction or arrangement should be to avoid tax.

It is submitted that the incredibly complex nature of the UK trust taxation framework detracts from the overall effectiveness. It may well be that the UK has the most comprehensive taxation system of all the jurisdictions for trusts, but it is questionable how successful the implementation is. Aside from the complex

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provisions, the legislation suffers from patchy drafting that adds to the problem. Although the South African approach is not perfect, it is far simpler. The relative simplicity greatly enhances certainty and compliance for taxpayers while upholding a reasonable level of fairness. In the case of Belgium, the fact that no domestic trust law exists complicates the comparison somewhat, but a proper evaluation can only be made after the discussion of the Cayman tax regime.

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CHAPTER 5: SPECIAL ANTI-AVOIDANCE RULES

5 1 Introduction

This chapter analyses and evaluates each jurisdiction's special anti-avoidance rules ("SAARs") as they are applied to trusts. The chapter will offer the reader a comprehensive overview of the relevant legislative provisions and illustrate the functioning thereof with practical examples. The chapter also examines the provisions' objects and determines whether it has been achieved. Finally, the chapter highlights potential shortcomings or areas where the regimes can be improved. As with previous chapters, the discussions in this chapter mainly focus on the income tax treatment of trusts; however, some SAARs that deal with other taxes, such as capital gains tax ("CGT") and death taxes, are also discussed to the extent that it is relevant.

In the context of South Africa, the death taxes are known as estate duty. Conversely, it is called inheritance tax in the United Kingdom ("UK") and Belgium while a jurisdiction such as Mauritius has no form of death tax. Aside from the different terminology used, taxes also operate in diverse ways. For one, in South Africa, estate duty is levied on the net value of a person's estate at death. This is in contrast to the UK and Belgium, where generally speaking, it is not the deceased that is subject to tax but rather the beneficiaries on the value of the inheritance received.

The chapter identifies and discusses the key similarities and differences between the main jurisdictions. The discussion builds on the discussions in the preceding chapters that introduced the reader to various concepts applied in each jurisdiction. Due to the complexity of the research subject, it is crucially important to have a reasonable understanding of the essential aspects of trusts, tax havens and the general taxation of trusts before one can focus on the SAARs, and possible recommendations that may follow.

The objective is reached by answering the following questions:

1. What are SAARs?
2. What scenarios are typically covered by SAARs?
3. Can more than one SAAR be applicable to the same circumstances?
4. To what extent does the SAAR operate in a given case? Or are there limitations to their operation?
5. Under what conditions will the SAAR cease to apply?
6. Who bares the onus of proof in respect of the application of the SAAR?

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Continuing with the practise in the prior chapters, this chapter also follows the comparative legal method. In order to promote and enhance consistency and to provide the reader with a complete picture of each main jurisdiction, each of these is discussed in its entirety before moving on to the next jurisdiction. This is in contrast to the alternative approach, where each subject or topic is completely dealt with before progressing to the next. It is acknowledged that it may result in some duplication between jurisdictions, but that is an unavoidable consequence of ensuring a clear and comprehensive overview while maintaining consistency throughout the rest of the dissertation.

5 2 South Africa

Building on the discussion in chapter 4, which outlined the general treatment of trusts for income tax purposes, the proceeding section will focus on discussing the various SAARs applicable to trusts. For purposes of this dissertation, the subsequent discussion is limited to the following SAARs[1]:

1. section 25B (2A);[2]
2. section 7; and[3]
3. section 7C.[4]

Aside from the main SAARs, depending on the circumstances, it may be possible that other SAARs must be considered in the context of trusts, even though such provisions usually do not apply to trusts. However, aside from the few points mentioned below, such provisions are outside the scope of this discussion.

In the context of corporate income tax, section 9D is a special anti-avoidance provision that regulates the taxation of foreign companies that are owned or controlled by South African resident taxpayers.[5] Section 9D aims to prevent taxpayers from using foreign companies to circumvent their tax liabilities.[6] The operation of the provision

[1] Although the application of FATCA, CRS, treaties and DTAs have an important role in the anti-avoidance fight, the aforesaid will not be discussed in this dissertation.
[2] Section 25B(2A) of the ITA.
[3] Section 7.
[4] Section 7C.
[5] Section 9D.
[6] Section 9D.

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attributes the proportional share of the foreign company's income to the resident taxpayer and is accordingly taxed in the resident's hands.

In recent years, the definition of a controlled foreign company ("CFC")[7] was amended to make it clear that section 9D extends to arrangements where South African resident taxpayers use foreign trusts to own the majority shares of a foreign company or through which the beneficiaries of the trust can exercise control over such foreign company. Previously, it was contended that such a foreign company would not constitute a CFC.

Although section 9D is aimed at companies, under specific instances, the ambit of the provision may extend beyond companies. Generally speaking, the provision is not applicable to trusts, but some foreign trusts that more closely resemble the legal form of a company and not that of a trust may also be subject to the provision. Despite the name trust assigned to such entities in their home jurisdiction, these so-called trusts function as companies and have similar characteristics to companies. In such a case, foreign trusts will be subject to the CFC regime, not the SAARs discussed in this chapter.

5 2 1 Section 25B(2A)

Following the discussion of section 25B, as encountered in paragraph 4 2 2, which dealt with assigning taxing rights among the different parties, a further provision of section 25B should be borne in mind. Section 25B(2A) of the Income Tax Act 58 of 1962 ("ITA") is a deeming provision that forms part of the ITA's wider measures to combat tax avoidance.[8] Thus, the provision is an anti-avoidance rule and should be interpreted as such. According to *Glen Anil Development Corporation Ltd v SIR*,[9] anti-avoidance provisions should be interpreted in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed. In order to give effect to the aforesaid, a purposive interpretation should be followed. [10] In light of this, it is submitted that the purpose of the provision is clear. It deals with distributions from non-resident trusts and aims to combat the

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[7] Section 1.
[8] JC Kanamugire "A critical analysis of tax avoidance in the South African Income Tax Act 58 of 1962, as Amended" (2013) 4 *MJSS* 351-364.
[9] 37 SATC 319.
[10] *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 4 SA 593 (SCA) 17.

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accumulation of foreign income in an offshore trust. In addition, the provision blocks any subsequent attempts to distribute said income as capital payments, which would circumvent paying income tax in South Africa.[11]

The relevant section reads as follows:

> "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, that amount must be included in the income of that resident in that year, if—
>
> (a) that capital consists of or is derived, directly or indirectly, 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 that resident had a contingent right to that amount; and
>
> (b) that amount has not been subject to tax in the Republic in terms of this Act."

The provision considers the situation where a resident beneficiary of a non-resident discretionary trust has a contingent right to the trust capital.[12] The provision is subsequently activated upon the vesting of such right. The vested right must be an amount representing the trust capital.[13] In such an instance, the provision requires that the accumulated income, which has become part of the trust capital, must be included in the beneficiary's income for the specific year of assessment during which the resident beneficiary acquires the vested right.[14]

The rule is only applicable if the capital arose from receipts and accruals of the trust, which would have constituted income if the trust had been a South African resident for any prior year of assessment during which the beneficiary had a contingent right to such income.[15] In addition, the workings of the provision will only be limited to the extent that the income has not previously been subjected to taxation in South Africa.[16] Moreover, if the beneficiary is merely a capital beneficiary, the beneficiary will

[11] RD Jooste "Offshore trusts and foreign income – the specific anti-avoidance provisions" (2002) *Acta Juridica* 186 201; DM Davis, C Beneke & RD Jooste *Estate Planning* (2016) para 6.3.1.
[12] M Honiball & L Olivier "Income tax principals" in *The Taxation of Trusts in South Africa* (2011) 76.
[13] D Clegg & R Stretch "Chapter 8: Residence, source, CFC rules and foreign tax credits" in *Income Tax in South Africa* (2021) para 8.5.14.
[14] AP Koker & RC Williams *Silke on South African Income Tax* (2021) para 12.18.
[15] L Olivier & M Honiball *International Tax: A South African Perspective* 5 ed (2011) 300.
[16] Clegg & Stretch *Income Tax in South Africa* para 18.2.

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not be liable. This is because the beneficiary would not have had a contingent right to the trust income in the earlier years of assessment.

In other words, if a non-resident trust makes a capital distribution to a South African beneficiary and, in a previous year of assessment, said amount would have constituted income if the trust was a South African resident, the beneficiary will be liable for income tax on that amount. If the capital distribution from the non-resident trust originates, for example, from receipts of foreign dividends, such dividends will not amount to income under the ITA if the participation exemption applies.

This can be illustrated by means of an example. Suppose a South African resident is a beneficiary of a discretionary offshore trust, which earns a mixture of rental and interest income. For the last four years, the trustees have made no distributions to the beneficiaries but rather left the income to accumulate in the trust. However, in year five, the trustees decide to distribute an amount to the South African resident beneficiary. At this point in time, the South African resident beneficiary no longer merely has a contingent right to the trust income but a vested right to that amount that was distributed to him. If the trust was a South African resident, the accumulated amounts would have constituted income in the relevant year of assessment and, thus, taxed accordingly. Therefore, the beneficiary will be liable to income tax on the accumulated income that accrues to them and not subject to CGT.

This section has been described as creating a legal fiction due to the manner in which a non-resident is treated as a resident.[17] The provision assumes that such income changes its legal nature to that of capital simply because it is accumulated in the hands of the trust rather than distributed to beneficiaries.[18]

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[17] Honiball & Olivier *The Taxation of Trusts in South Africa* 23.

[18] Olivier & Honiball *International Tax: A South African Perspective* 300. The assumption contained in the provision is in contrast to the view expressed by the courts, as well as the long-standing and accepted conduit principle. In *Armstrong v CIR* 1938 AD 343 ("*Armstrong*"), the court held that income that is the subject of a trust retains its identity until it reaches the party in whose hands it is taxable. This view was confirmed in *SIR v Rosen* 971 1 SA 173 (A) ("*Rosen*") but added a qualification. In an obiter dictum the court held that it is possible that the conduit principle can turn itself off. This will be the case where income is accumulated in the trust and only distributed to a beneficiary in a subsequent year of assessment. Such income will lose its identity and be regarded as capital in the beneficiary's hands. The reasoning behind this line of thought may be the fact that taxation is regarded as an annual event. It should be observed that the statement was obiter. Regardless, it is important to take note thereof, especially since it is a Supreme Court of Appeal case. In the subsequent case of *Estate Dempers v CIR* 1977 3 SA 410 (A) ("*Estate Dempers*"), the court followed the reasoning in *Armstrong* and *Rosen*, but without the qualification. There the court held that accumulated income that is capitalised and added to the trust fund could not alter its essential character as income rather than capital. According to De Koker

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If one continues with the example above, suppose the accumulated trust income rather consists of foreign dividends; then that amount received will not be subjected to tax in the South African resident beneficiary's hands. This is by virtue of the participation exemption bestowed on residents. The rationale stems from the fact that the accumulated foreign dividends would not have constituted income if the trust was a resident but instead would have been regarded as exempt income. This means that the participation exemption also applies to the vesting of prior-year foreign dividends received by an offshore trust, which subsequently vests to a South African resident beneficiary.

The rule is only applicable if the capital arose from receipts and accruals of the trust that would have constituted income if the trust had been a South African resident.[19] This means that income, such as income from local dividends that would have been exempt if received by a resident, does not form part of income for purposes of section 25B(2A). In addition to the aforesaid, local dividends would be from a South African source.[20] For this reason, local dividends would also fall outside the ambit of this provision. Therefore, if a non-resident trust receives it, this exemption still applies if distributed to a resident beneficiary in a future tax year.[21] However, an important caveat limits the exemptions afforded to beneficiaries.

The relevant section reads as follows:

"In determining, for purposes of subsection (2A), whether an amount received by or that

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and Williams, it is possible to harmonise the resulting conflict between the *Estate Dempers* case and the assumption in section 25B(2A) by not following the widely accepted twin concept proposition, which states that an amount must either be income or capital. In such a scenario, capital will not be assigned its normal meaning of an amount other than income. For this line of thought to be successful, one must accept the notion that there may exist an alternative category which is not limited to income or capital. Hence, in the context of s 25B(2A), capital must be interpreted as something in-between. In other words, connoting no more than an amount added to the trust fund in accordance with the trust deed. Should this interpretation be followed, it will resolve the conflict between the *Estate Dempers* case and s 25B(2A) of the ITA. Such interpretation can be equated with the view that in the hands of a borrower, a loan is colourless. However, it is submitted that a departure of the distinction between income and capital is not desirable. Instead, it is considered that the reading of the *Estate Dempers* case is incorrect. The more likely interpretation of *Estate Dempers* is that the remarks were in the context of s 7(5) and not the conduit pipe principle. Hence, the preferred view is that the ratio in *Rosen* must be followed. Such construction will also eliminate the assertion that there is a conflict between the *Estate Dempers* case and the assumption in s 25B(2A).

[19] De Koker & Williams *Silke on South African Income Tax* para 12.21.

[20] Section 9(2)(A) of the ITA and s 1: definition of "dividend".

[21] Clegg & Stretch *Income Tax in South Africa* para 18.2.

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accrued to a trust which is not a resident would have constituted income had that trust been a resident, the provisions of section 10B (2) (a) must be disregarded in respect of an amount received or accrued consisting of or derived, directly or indirectly, from a foreign dividend—

(i) paid or payable by a company if—

(aa) more than 50 per cent of the total participation rights, as defined in section 9D (1), or of the voting rights in that company are directly or indirectly held or are exercisable, as the case may be, by that trust whether alone or together with any one or more persons that are connected persons in relation to that trust; and

(bb) that resident or any person that is a connected person in relation to that resident is a connected person in relation to that trust; and

(ii) to the extent to which that foreign dividend is not derived from an amount that must be included in the income of or that must be attributed as a capital gain to—

(aa) the resident who acquired the vested right to the amount referred to in subsection (2A); or

(bb) a resident who is a connected person in relation to the resident referred to in item (aa)."[22]

Section 25B(2B) was recently enacted to place a limitation on the participation exemption where offshore trusts are used. In essence, it provides that where a foreign trust receives dividends from a foreign company, in which the trust can exercise more than 50% of the participation or voting rights in said company, either by itself or collectively through any connected person, then the participation exemption will not be available to the South African resident beneficiary.[23] However, this provision does not apply to a foreign dividend that is derived from an amount that must be included in the income of or attributed as a capital gain to that resident or to any person who is a connected person in relation to said resident.[24]

If one revisits the example above, let's suppose that the non-resident trust owns 60% of the shares in foreign company X. Company X declared dividends for five consecutive years, but for the first four years, the dividend income is accumulated in the trust without distributing it to any beneficiaries. Only in year five do the trustees decide to make a distribution to the South African resident beneficiary. In this case,

[22] Section 25B(2B) of the ITA.
[23] De Koker & Williams *Silke on South African Income Tax* para 12.22.
[24] Para 12.22.

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the distributed amount will not be exempt from income tax in the resident beneficiary's hands. This is because the participation exemption pertaining to foreign dividends will no longer be applicable due to the fact that the trust controls more than 50% of the participation or voting rights in company X, which issued the dividends. If the trust only owned 40% of the shares, the exemption would have been available to the resident beneficiary. It should be noted that the determining factor is not whether the trust owns in excess of 50% of the shares in the company but rather whether the trust can control more than 50% of the participation or voting rights in the company. This means that even if the trust owns 40% of the shares, but parties related to the trust collectively own more than 10%, the trust will satisfy the ownership threshold.

It is still unclear whether the South African resident beneficiary can benefit from section 10B(3) of the ITA with respect to such capital distribution.[25] In terms of this provision, all foreign dividends are afforded a partial tax exemption. In the academic fraternity, there is the view that this should indeed be the case.[26] It is submitted that the aforesaid view is correct and that the provision should be amended to provide clarity.

This provision largely hinges on the premise that the beneficiary has a contingent right to the trust's income before it is distributed in later years.[27] The ITA contains no definition for the term "contingent right", however, case law can provide some guidance on how this phrase should be interpreted.

In *Estate Dempers,*[28] the court explained it as follows: "A "contingent event" (Afrikaans text: "ongewisse gebeurtenis") is an event which may or may not happen. A "fixed event" (Afrikaans: "gewisse gebeurtenis") is the converse: it is an event which will certainly and inevitably happen".

Further, in *Jewish Colonial Trust v Estate Nathan,*[29] the court stated that "[t]he word 'contingent' is also used to describe a right which is conditional and uncertain as opposed to a vested right which is certain, unconditional and immediately acquired, even though in some instances enjoyment of the right may be postponed".

In *Durban City Council v Association of Building Societies*,[30] the court described

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[25] Davis, Beneke & Jooste *Estate Planning* para 6.1.
[26] De Koker & Williams *Silke on South African Income Tax* para 12.22.
[27] Clegg & Stretch *Income Tax in South Africa* para 18.3.
[28] 1977 3 SA 410 (A).
[29] 1940 AD 163, 175-176.
[30] 1942 AD 27 33-34.

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the term contingent right as "the conditional nature of someone's title to the right". The court further held that: "A right under a will or contract may be contingent in the sense that, though imperfect at the time of its creation, it is capable of becoming perfect on the happening of some uncertain, future event".

It can be argued that section 25B(2A) could fail, as the interest of a discretionary beneficiary can possibly be described as a *spes* or a mere hope, as opposed to a contingent right.[31] However, the consensus within the academic fraternity is that the interest of a beneficiary under a discretionary trust does constitute a contingent right within the meaning of section 25B(2A).[32] This view is supported by Cameron et al's statement that "if a trustee has a discretion not merely how, but also whether to pay income or distribute capital to the beneficiary, then the latter's right is merely contingent".[33]

This means that in the context of this provision, the term contingent right should be interpreted to mean the beneficiary's interest in the trust's income. It is not correct to equate this to a *spes* or mere hope. Even though the beneficiary's right is contingent on the trustees exercising their discretion in favour of said beneficiary, the beneficiary's interest in the trust's income may still be something of value.[34]

It is unclear whether the section would apply if a beneficiary only had a contingent right to the income for part of the year. It may be argued that the section is not applicable if the beneficiary does not have a contingent right to the income at the end of the year of assessment.[35] However, it is submitted that the preferred view is rather that the applicability of said provision is not affected by the extent of the year in which the contingent right to the trust's income existed. This view can be explained by following the literal interpretation of the phrase "in any previous year of assessment during which that resident had a contingent right to that amount".[36] Based on this reasoning, it can be inferred that any such right for any period during the tax year would constitute sufficient grounds for the subsection to apply.

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[31] Clegg & Stretch *Income Tax in South Africa* para 5A.7.3.1.
[32] De Koker & Williams *Silke on South African Income Tax* para 12.18; D Davis, L Olivier, G Urquhart, R Engels-van Zyl, J Roeleveld *Juta's Commentary on Income Tax* (1999); Davis *et al Estate Planning* para 6.3.1.
[33] *Ovenstone v SIR* 1980 2 SA 721(A) D.
[34] De Koker & Williams *Silke on South African Income Tax* para 12.21.
[35] Olivier & Honiball *International Tax: A South African Perspective* 307.
[36] De Koker & Williams *Silke on South African Income Tax* para 12.23.

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Following from the former, the question can be raised whether there should not rather be some form of apportionment, if the beneficiary only had a contingent right to the trust's income for a part of the year prior to the distribution.[37] However, if one considers the nature of income tax and that it is regarded as an annual event, it strongly suggests that a pro rata apportionment is not appropriate.

Based on the above, it is clear that if the resident beneficiary is only a capital beneficiary of the non-resident trust, the beneficiary will not be subjected to income tax on said amount received from the trust. Depending on the circumstances, it is, however, possible that the distribution may incur a liability for CGT.

By way of an example, let's suppose that after five years of consistent growth, the non-resident trust sells a part of its share portfolio at a sizable profit. In the subsequent year, the trustees decide to distribute a portion of the proceeds to the South African resident beneficiary. The sale of shares constitutes a disposal of an asset, which means that any proceeds are capital in nature. In such case, the distributed amount would not have constituted income if the trust was a resident, because the amount is capital in nature, thus, this provision will not be applicable. Hence, the resident beneficiary will have no income tax consequences on the received amount. However, the distribution may incur a CGT liability.

Continuing with the example, let us rather suppose that instead of selling a part of the share portfolio, the trustees decide to accumulate all dividends received for a period of five years. After the five years have lapsed, the trustees elect to distribute a portion of the accumulated amount to the South African resident beneficiary. However, in this case, the South African resident beneficiary is only a capital beneficiary of the non-resident trust. In such a case, the amount received by the resident beneficiary will not be caught by the working of this provision. Therefore, no income tax liability will ensue, but there may be CGT consequences.

The exclusion of capital beneficiaries can be explained by the notion that a capital beneficiary would not have been entitled to the trust income or had a contingent right to the income in the prior years. Therefore, only an income beneficiary will satisfy the requirements of the provision, once the contingent right has ceased to exist and vesting has occurred. In such case, the decision by the trustees to distribute an amount to the resident beneficiary is the event that converts an imperfect right to a perfect

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[37] Honiball & Olivier *The Taxation of Trusts in South Africa* 77.

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right, or differently put, that allows vesting to take place.

Furthermore, the liability centres on the premise that the beneficiary is a resident during the year that he acquires the vested right to the capitalised trust income.[38] For purposes of this provision, it is irrelevant whether the beneficiary was always a resident, or only became a resident throughout the last mentioned year.[39] Conversely, if the beneficiary is a non-resident during such year, no tax liability will follow for the subsequent distribution, regardless of the fact that the beneficiary was a resident throughout the contingent period.

The scope of this provision extends to include income from all sources, provided that it has not been subjected to tax in South Africa.[40] In most instances, income derived from sources within or that is deemed to be from within South Africa would already have been taxed in terms of other provisions of the ITA. Depending on the circumstances, it is possible that such income could also have been subjected to tax in the Republic by virtue of the application of section 7(5)[41] or 7(8).[42] In such a case, those sources are excluded from the reach of this provision. This qualification is added for the taxpayer's benefit and, hence, prevents the income from being subjected to economic double taxation. It can thus be argued that, should SARS fail to tax income by applying section 7(5) or 7(8) in the year that the income accrues to the trust, then SARS cannot recover said tax by applying section 25B(2A) to the accumulated income in a subsequent year when the income is distributed as capital. In addition, foreign-sourced income is also covered under section 25B(2A), but the taxation thereof is effectively postponed until the income vests in the South African resident beneficiary.[43]

In interpreting the concepts of income, receipts and accruals, it has been held that the normal definition used in the ITA, and the meanings as set out in case law, must be followed respectively.[44]

It is important to note, that the taxpayer will bear the onus to prove that the provision should not be applicable. For example, the taxpayer would have to prove that the distribution made by the offshore trust, would not have constituted income if

[38] Davis, Beneke & Jooste *Estate Planning* para 6.2.
[39] Section 25(2A) of the ITA.
[40] Clegg & Stretch *Income Tax in South Africa* para 5A.7.3.1.
[41] De Koker & Williams *Silke on South African Income Tax* para 12.28.
[42] Para 12.32.
[43] Honiball & Olivier *The Taxation of Trusts in South Africa* 77.
[44] 78.

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the trust were a resident.[45] In such case, the beneficiary will need to show that either the income is exempt or that it is genuinely from capital and not from accumulated income. This means that it may be necessary for the beneficiary to submit the trust deed and trust accounts into evidence.

Thus, in summary, if any one of the following circumstances apply, section 25B(2A) will no longer be applicable:

1. If the beneficiary did not have a contingent right when the income accrued to the trust.[46]
2. If the beneficiary is not a resident at the time that the beneficiary acquires a vested right to the capital, even if the beneficiary was a resident while the beneficiary had a contingent right to the trust income.[47]
3. If the trust capital that is being distributed to a capital beneficiary truly arises from income that was capitalised in the trust over a period of time.[48]
4. If the income has already been subject to tax in South Africa.[49]
5. If the receipts and accruals of the trust did not constitute income as defined.[50]

5 2 2 Section 7

Generally speaking, no tax liability can arise in the absence of a receipt or accrual.[51]

However, in certain circumstances, the ITA makes an exception to this rule. In such instances, income is attributed to another taxpayer, even though it did not accrue to, or was not received by that taxpayer. This is known as the attribution principle.[52]

There are various statutory anti-avoidance measures which determine the circumstances where income is deemed to be a person's income, notwithstanding the fact the income in question has not legally been received or accrued to that person.[53]

[45] De Koker & Williams *Silke on South African Income Tax* para 12.32.
[46] Jooste (2002) *Acta Juridica* 202; Davis *et al Estate Planning* para 6.3.1.
[47] De Koker & Williams *Silke on South African Income Tax* para 12.15C.
[48] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 25B(2A).
[49] Section 25B(2A)(b) of the ITA. Jooste (2002) *Acta Juridica* 201-202; De Koker & Williams *Silke on South African Income Tax* para 12.15C; Davis *et al Estate Planning* para 6.3.1.
[50] Honiball & Olivier *The Taxation of Trusts in South Africa* 78-82.
[51] De Koker & Williams *Silke on South African Income Tax* para 12.28.
[52] Para 12.28.
[53] Clegg & Stretch *Income Tax in South Africa* para 17.3.5.

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Section 7 of the ITA contains a number of deeming provisions that directly impact how income generated by property held in the name of a trust is taxed.[54] These deeming provisions are also referred to as anti-avoidance provisions since they deem income which has accrued to the trust, or which has accrued to a beneficiary of a trust to accrue to someone else.[55] This person is normally the person who orchestrated the accrual to not occur in his hands, but rather in the hands of the other person (the beneficiary or the trust) to reduce the normal tax liability.[56] This is often achieved by having the amount taxed in the hands of someone in a lower tax bracket. It is precisely this kind of behaviour that section 7 attempts to prevent.

Section 7 of the ITA is of particular relevance to trusts, but its application is not limited to trusts alone.[57] It deals with income accrued by reason of a donation, settlement or other disposition.[58] It further outlines the rules that regulate under which circumstances income that is the subject of a trust will not be taxed in the hands of the trust or of any beneficiary, but rather in the hands of the donor or founder of the trust.

It should be noted that within the context of this provision, the term “donor” does not necessarily mean the founder of a trust or person who initially settled property upon a trustee for the benefit of certain beneficiaries.[59] After the trust has been created, a third party can donate to the trust. In turn, the income generated by such donation could be deemed to be the income of the third party under one or other of the provisions of section 7 if all the requirements are satisfied.[60] The resulting income will thus be taxed in the third party’s hands and not in the hands of the founder of the trust. Hence, the operation of this provision is not limited to the founder, but to any person who falls within the ambit of any of the subsections of section 7.

The phrase “donation, settlement or other disposition” used throughout section 7 has led to a debate regarding the exact meaning and scope thereof.[61] For the purpose of this section, the ITA defines a donation as any disposal of assets for a consideration which is less than the market value, or such portion less than the market value of such

[54] Honiball & Olivier *The Taxation of Trusts in South Africa* 84.
[55] 84-85.
[56] Davis, Beneke & Jooste *Estate Planning* para 6.3.
[57] Para 6.3.
[58] Davis *et al Juta’s Commentary on Income Tax*, Commentary on s 7.
[59] Clegg & Stretch *Income Tax in South Africa* para 17.3.5.
[60] Para 17.3.5.
[61] Para 17.3.5.

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asset.[62] *Ovenstone v SIR* ("*Ovenstone*") [63] described a donation to mean "the donor disposes of the property gratuitously out of liberality or generosity, the donee being thereby enriched and the donor correspondingly impoverished, so much so that, if the donee gives any consideration at all, therefore, it is not a donation".[64] The court further held that it is a unilateral agreement in terms of which obligations are only conferred on the donor.[65]

The word "settlement" is similar in nature to donation. It was most likely included to cover the situation where a transaction in form, substance, or effect does not squarely fall within the meaning of a donation.[66] In turn, the court defined it as

> "[in] a 'settlement' the property is usually disposed of upon specific terms and conditions, set out in a deed of settlement, to or through the medium of a trustee or trustees for the benefit of some persons, or for the benefit of persons in succession as in a *fideicommissum* … As far as the beneficiaries are concerned a settlement is also generally made gratuitously out of liberality or generosity in the sense that no consideration usually passes from them to the settlor for the benefits conferred on them."[67]

In *Joss v SIR* ("*Joss*"), [68] the court held that transactions that are paid for in full, either in money or in some other form that is equal to the value, are excluded from the meaning of settlements for the purposes of this section. Furthermore, the court expressed the view that transactions in this category are inextricably connected with a generous motive.[69]

The more problematic part of the phrase is "or other disposition".[70] The fact that these words are not defined in the ITA exacerbates the problem.[71] The ordinary meaning refers to "any making over, parting with or transferring of property to

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[62] Section 7(9) of the ITA.
[63] 1980 2 SA 721(A).
[64] *Ovenstone v SIR* 1980 2 SA 721(A) 732 B-C.
[65] 732 B-C.
[65] 732 C.
[66] De Koker & Williams *Silke on South African Income Tax* para 12.28.
[67] *Ovenstone v SIR* 1980 2 SA 721(A) 732 C.
[68] 1980 1 SA 674 (T).
[69] *Joss v SIR* 1980 1 SA 674 (T) 638 A-B.
[70] Honiball & Olivier *The Taxation of Trusts in South Africa* 86.
[71] De Koker & Williams *Silke on South African Income Tax* para 12.28.

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another".[72] In this form, it will include loans and *bona fide* commercial transactions. It is clear that such a wide interpretation cannot be correct. It is therefore submitted that a narrower meaning should be used. In *Barnett v COT* ("*Barnett*"),[73] the court, however, adopted the normal meaning and held that it could include a commercial transaction.[74] This was also the approach SARS followed for some time.[75]

The court has held that the intended aim of section 7 is to address transactions "in which a taxpayer seeks to achieve tax avoidance by donating, or disposing of an income-producing property to or in favour of another under the "specified conditions or circumstances, thereby diverting its income from himself without his replacing or being able to replace it".[76] The decision in the *Ovenstone* case, therefore, overruled the stance adopted in *Barnett.* It is submitted that this is a welcoming departure and more in line with the purpose of the provision.

In *CIR v Berold* ("*Berold*"),[77] the court held that an interest-free loan constitutes a continuing donation. In such a scenario, the interest that should have been charged will be deemed a donation.[78] The amount of interest is that which is regarded as normal under the specific circumstances of the case. In other words, the rate which the person would have been charged if it was a *bona fide* arm's length arrangement. In the *Joss* case the court elected to rather classify such acase under "other disposition".[79] In the *Ovenstone* case, the court held that the terms donation and settlement are technical legal terms.[80] For that reason, the legislator inserted the more general term "disposition".[81] Regardless of the grouping, the effect of section 7 on interest-free loans however remains unchanged.[82]

The court also considered this matter in *SARS v Woulidge* ("*Woulidge*").[83] In this case, the court did not specify exactly under which part of the phrase an interest-free

[72] Clegg & Stretch *Income Tax in South Africa* para 17.3.5.
[73] *Barnett v COT* 1959 2 SA 713 (FC) 326.
[74] 326.
[75] South African Revenue Service "Interpretation Note 9 – Small Business Corporations" (15-06-2009) *SARS* <https://www.sars.gov.za/lapd-intr-in-2018-08-arc-08-in9-issue-6-small-business-corporations/> (accessed 08-03-2022)
[76] *Ovenstone v SIR* 1980 2 SA 721(A) C.
[77] 1962 3 SA 748 (A)
[78] Clegg & Stretch *Income Tax in South Africa* para 17.3.5.
[79] *Joss v SIR* 1980 1 SA 674 (T).
[80] *Ovenstone v SIR* 1980 2 SA 721(A) D.
[81] Honiball & Olivier *The Taxation of Trusts in South Africa* 86.
[82] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[83] *South African Revenue Service v Woulidge* [2002] 2 All SA 199 (A) para 3.

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loan will fit in, notwithstanding the fact that it will be treated as a continuing donation for section 7.[84]

Therefore, the words "donation" and "settlement" must be interpreted as dispositions involving an appreciable element of liberality or generosity.[85] This can either be in full or partially.[86] Furthermore, the expression "other disposition" must be interpreted as any disposal of property made wholly or to an appreciable extent gratuitously out of the liberality or generosity of the disposer.[87] It should therefore be interpreted within the context of the preceding concepts. The more appropriate worded phrase should thus rather be "donation, settlement or other *similar* disposition".[88]

In the *Ovenstone*[89] case, the court decided that a transaction where the consideration is merely illusory, simulated, or minimal would be treated as an entire donation. Consequently, just because an agreement contains some element of generosity or gratuitousness does not immediately result in the applicability of section 7.[90] Such gratuitousness must be appreciable and not merely insignificant. Apportionment is the appropriate remedy where the donation contains both elements of gratuitousness and consideration.[91] In the *Joss* case, the court held that in order to give proper effect to the real cause of the accrual or receipt of the income, the words, "by reason of" inherently suggest some apportionment is necessary.[92] If such apportionment is not possible, or if insufficient evidence exists to make the determination, the composite disposal will usually be regarded as a gratuitous settlement or disposition. The result can be attributed to its substantial nature.[93] In the *Woulidge* case, the court concurred with the rationale in the *Ovenstone* case, but reiterated that the taxpayer bears the burden of proof to show that such an apportionment is possible and how a court should give effect to the apportionment. However, the court did qualify the statement made in the Joss case that held that the apportionment is a logical necessity and that an allocation must be

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[84] Para 6.
[85] Davis, Beneke & Jooste Estate Planning para 6.3.
[86] Clegg & Stretch *Income Tax in South Africa* para 17.3.5.
[87] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[88] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[89] *Ovenstone v SIR* 1980 2 SA 721 (A).
[90] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[91] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[92] *Joss v SIR* 1980(1) SA 674 (T) 206.
[93] 206.

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made for tax purposes.[94] Instead, the court found that in each case the possibility and extent of an apportionment is a matter of fact.[95] Therefore, depending on the facts of the case, an apportionment may not always be possible.

Throughout section 7 the provision is qualified by using either the words "by reason of" or the phrase "by reason of or in consequence of".[96] However, none of these terms is defined in the ITA. In *Kohler v CIR,*[97] the court held that it denotes the causal link or connection between the donation and the accrual or receipt of the income in question.[98] Therefore, the generated income must be attributable to the initial donation before section 7 is applicable. Furthermore, the court elected to limit the scope of the provision by restricting it to primary income derived from the donation.[99] On the facts of the case, the court had to consider if the provision also covers income earned from the re-investment of income. The court concluded that the action of re-investing broke the causal link that existed between the donation and the income. The new causal connection is the act of re-investing the funds. Therefore, secondary income or income from income falls outside the scope of this provision.[100]

The Supreme Court in the *Widan vs CIR*[101] case subsequently overruled this decision. The court said that it is unlikely that the legislature would have intended such a narrow interpretation.[102] Therefore, even if income is reinvested the causal link remains in place.[103] The result of this is that secondary income, or income from re-investing income will also be subject to section 7.[104] Moreover, the court held that the determination of the causal connection should be dealt with on a case-by-case basis.[105] In addition, all the facts and circumstances must be taken into account. The court, however conceded that in the instance where a donation is made, and the child's skills or labour is used to generate income, such income will not be regarded as

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[94] 206.
[95] 206.
[96] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[97] 1949 4 SA 1022 (T).
[98] *Kohler v CIR* 1949 4 SA 1022 (T).
[99] *Kohler v CIR* 1949 4 SA 1022 (T).
[100] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[101] 1955 1 SA 226 (A).
[102] *Widan v CIR* 1955 1 SA 226 (A).
[103] Clegg & Stretch *Income Tax in South Africa* para 17.3.5.
[104] Olivier & Honiball *International Tax: A South African Perspective* 305.
[105] *Widan v CIR* 11955 1 SA 226 (A).

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income derived from the donation.[106] Furthermore, it is also possible that an apportionment can be made if the facts support such approach.[107]

5 2 2 1 Section 7(2)

As a general rule, spouses are separately assessed for tax in respect of all income that is received by or that accrues to the individual spouses.[108] However, this is not the case if one of the anti-avoidance provisions applies in the circumstances. Only in such a case will income received by or accrued to a spouse be deemed to be income accrued to the other spouse.[109]

Section 7(2) is an anti-avoidance provision that aims to prevent income splitting between spouses. The provision targets the situation where taxpayers attempt to reduce their tax liability by exploiting the fact that spouses are taxed separately.[110] Typically, this can take the form of transferring income-producing assets to the other spouse that falls in a lower tax bracket or by awarding excessive remuneration to a spouse from the trade operations of the other spouse.[111] By virtue of the provision, the income that arises from the donation will be deemed to be that of the donor spouse and taxed accordingly in that spouse's hands, provided that all the other requirements of section 7(2) are complied with.

The relevant section reads as follows:

"(2) Any income received by or accrued to any person married in or out of community of property (hereinafter referred to as the recipient) shall be deemed for the purposes of this Act to be income accrued to such person's spouse (hereinafter referred to as the donor) if—

(a) such income was derived by the recipient in consequence of a donation, settlement or other disposition made by the donor on or after 20 March 1991 or of a transaction, operation or scheme entered into or carried out by the donor on or after that date, and the sole or main purpose of such donation, settlement or other disposition or of such transaction, operation or scheme was the

[106] 341.
[107] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[108] Honiball & Olivier *The Taxation of Trusts in South Africa* 86-87.
[109] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[110] Davis, Beneke & Jooste Estate Planning para 6.3.
[111] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.

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reduction, postponement or avoidance of the donor's liability for any tax, levy or duty which, but for such donation, settlement, other disposition, transaction, operation or scheme, would have become payable by the donor under this Act or any other Act administered by the Commissioner; or

(b) income was received by or accrued to the recipient—

(i) from any trade carried on by the recipient in partnership or association with the donor or which is in any way connected with any trade carried on by the donor; or

(ii) from the donor or any partnership of which the donor was at the time of such receipt or accrual a member or any private company of which the donor was at such time the sole or main holder of shares or one of the principal holder of shares, and such income represents the whole or any portion of the total income so received by or accrued to the recipient which exceeds the amount of income to which the recipient would reasonably be entitled having regard to the nature of the relevant trade, the extent of the recipient's participation therein, the services rendered by the recipient or any other relevant factor; or

(c) …" [112]

Section 7(2)(a) applies to spouses, regardless of whether they are married within community of property or not. Furthermore, it is irrelevant which spouse makes the donation and which spouse is on the receiving end. The provision refers to the spouse that is liable for the payment of tax in respect of such deemed income as the donor, while the other spouse that receives the donation is referred to as the recipient.

It should be noted that the subsections that only apply to a specific matrimonial regime fall outside this dissertation's ambit and will not be discussed. Hence, section 7(2A) and (2C), which pertains to spouses married in community of property will not be dealt with.[113]

The term spouse is defined as a person who is the partner of another person in either a marriage or customary union recognised by South African law, or a union recognised as a union in terms of any religion or a same-sex or heterosexual union which is intended to be permanent.[114]

[112] Section 7(2) of the ITA.
[113] Section 7(2A) and (2C).
[114] Section 1 "Definition of spouse".

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Based on the provision, it is evident that section 7(2)(a) can apply to donations directly between spouses, but the ambit of the provision is not limited to the aforesaid scenario. Equally, the provision can also apply to the situation where a trust is interposed between the two spouses.[115]

Thus, for example, section 7(2)(a) will apply in the instance that spouse A formed an *inter vivos* trust and donated income-generating assets to the trust for the benefit of spouse B. In such case, any income which accrues to spouse B in consequence of the donation will be deemed to be that of spouse A. Provided that all the other conditions of section 7(2)(a) are satisfied.

If the provision applies, by virtue of section 7(2)(a), the income that is received by or that accrues to the recipient spouse, in consequence of the donation, is deemed to be that of the donating spouse.[116] However, the operation is limited to the income that arises from the donation.[117] This means that no income tax liability will ensue if the donated asset does not generate any income.

In *CIR v Shell Southern Africa Pension Fund,*[118] the court held that the words "in consequence of a donation ... or transaction" should not be interpreted as being the *conditio sine qua non* but should rather be understood to mean the effective cause of the income that accrues to the recipient. Hence, the phrase 'in consequence of' is similar to the phrase "as a result of" and requires the finding of the effective causal connection as to the accrual of the income.[119]

Differently put, there appears to be no difference between the meaning of "in consequence of" in section 7(2)(a) and the words "by reason of" as is encountered in section 7(3).

The prerequisite for section 7(2)(a) is that there must first be a donation, settlement or other disposition or a transaction, operation or scheme.[120] However, before the subsection can apply it must be established that the sole or main purpose of the arrangement was to avoid, postpone or reduce tax. Hence, there is an element of intent required.

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[115] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[116] Para 17.3.6.
[117] Davis, Beneke & Jooste Estate Planning para 6.3.
[118] 1984 1 SA 672 (A).
[119] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[120] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.

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The phrase transaction, operation or scheme is not encountered anywhere else in section 7.[121] Instead, it is the same phrase that is used in the general anti-avoidance provisions. The inclusion of the aforesaid phrase means that section 7(2)(a) has a much wider ambit than any of the other subsections of section 7, but the exact demarcation is unclear. However, it is submitted that section 7(2)(a)'s ambit extends beyond the requirement of gratuitousness, liberality or generosity, which is a requirement for a disposition to be a donation, settlement or other disposition.

Following from the above, it means that SARS could successfully challenge, for example, an interest-free loan on two bases: first, it could be argued that said loan is a partly gratuitous transaction, and hence, an apportionment should be made. Second, the loan can also be regarded as a transaction and as a result may fall completely within the ambit of section 7(2)(a).

Although section 7(2)(a) adopts the phrase used in the general anti-avoidance provisions, section 7(2)(a) does not require that the arrangement constitutes an abnormal transaction, operation or scheme or that the arrangement has created rights or obligations which would not normally be created between persons dealing at arm's length. Instead, the application of the provision hinges on the main purpose of the arrangement.[122]

According to *Hicklin v SIR*,[123] the proper test to be applied in the determination of the purpose of a transaction, operation or scheme is a subjective test, which adopts as its yardstick the sole or main purpose that the taxpayer in carrying out the scheme intends to achieve by said arrangement.

In light of the above, it means that if the taxpayer can show that his sole or main purpose was not tax-related, section 7(2)(a) cannot be applied. However, the mere assertion by the taxpayer that his sole or main purpose was not the avoidance of tax does not carry much weight.

In order to displace the presumption against him, the taxpayer must be able to point to some other compelling reasons for entering into the arrangement.[124] Due to the subjective nature, it is submitted that it is a burdensome onus on the taxpayer.

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[121] Davis, Beneke & Jooste Estate Planning para 6.3.
[122] Clegg & Stretch *Income Tax in South Africa* para 17.3.16.
[123] 1980 1 SA 481 (A).
[124] Davis, Beneke & Jooste Estate Planning para 6.3.

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Thus, a taxpayer could argue that the sole or main purpose for transferring income-producing assets into a trust, for the benefit of his spouse by way of a donation or similar gratuitous disposition was to protect himself against the possibility of insolvency. However, for this defence to be successful, the taxpayer would have to prove that there was some reasonable contemplation of that possibility in order to discharge the onus. If the taxpayer succeeds, the provision cannot be invoked, but if the claims cannot be substantiated, the income arising from the donation will be deemed to be that of the donating spouse and taxed accordingly.

Based on the wording used, it is clear that section 7(2)(a) is not limited to income tax, but extends to the avoidance of any liability to tax.[125] In addition, it is not sufficient that the purpose of the arrangement is to avoid tax liability, but the arrangement must actually achieve the intended objective.[126] Only if that is the case can the income be deemed to be the donor's. This means that if the purpose of a disposition is, for example, to avoid value-added tax, which is unsuccessful, but instead income tax is avoided, section 7(2)(a) cannot apply so as to deem the income resulting from the arrangement to be that of the donor.

Section 7(2)(b) targets a situation where one spouse carries on a trade and overpays the other spouse, without said spouse contributing the equivalent value. By splitting the income between the donor spouse and the recipient spouse, their overall income tax liability is reduced.

Therefore, section 7(2)(b) applies to either spouse whose income from a trade associated or in partnership with the other spouse is excessive having regard to all relevant factors and circumstances of the case.[127] If the amount derived is regarded as being excessive, only the excessive part of the recipient spouse's remuneration is deemed to be the income of the other spouse and taxed accordingly in that spouse's hands.[128]

However, if the income earned by the recipient spouse is considered to be reasonable, having regard to the nature and extent of said spouse's duties, such

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[125] Para 6.3.
[126] Clegg & Stretch *Income Tax in South Africa* para 17.3.6 and para 15.7.
[127] Paras 17.3.6 and para 15.7.
[128] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.

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income is taxed separately in such spouse's hands, even though the income is derived from a trade connected with the other spouse.[129]

Unlike the other subsections of section 7, the taxpayer does not have the right to recover from the other spouse the tax paid due to the deemed income being included in the donating spouse's assessable income.[130]

Section 7(2B) expressly provides that deductions or allowances that may be made in determining the taxable income of any spouse derived from any income referred to in section 7(2) follow the accrual of the income.[131] Thus, the spouse to whom income accrues or is deemed to accrue is entitled to the deductions or allowances relating to such income.

The relevant section reads as follows:

> "(2B) So much of any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived from any income referred to in subsections (2) and (2A) as relates to any portion of such income which is under the provisions of that subsection deemed to be income accrued to a spouse shall be deemed to be a deduction or allowance which may be made in the determination of the taxable income of such spouse." [132]

Throughout the subsections of section 7, the general rule is that when the person who makes the donation, settlement or other disposition dies, the section 7 anti-avoidance provisions can no longer apply to the income which flows from the donation, settlement or disposition.[133] Likewise, this is also the position adopted under section 7(2). Hence, the operation of the provision ceases at the death of the donor spouse. However, there could be exceptions to this rule.[134]

5 2 2 2 Section 7(3)

Under normal circumstances, income that accrues to or that is received by a minor in its own right will be subject to tax in the minor's hands if it exceeds the taxable

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[129] Clegg & Stretch *Income Tax in South Africa* para 15.7.
[130] Paras 17.3.6 and para 15.7.
[131] Paras 17.3.6 and para 15.7.
[132] Section 7(2B) of the ITA.
[133] De Koker & Williams *Silke on South African Income Tax* paras 10.60 and 12.29.
[134] Clegg & Stretch *Income Tax in South Africa* paras 17.3.6 and 15.7.

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threshold.[135] (If an individual's total income for the year of assessment is below the taxable threshold, the individual will have no income tax liability. For the 2022 tax year, this threshold is R91 250.00).[136] However, if the income received by or accrued to is by reason of any donation, settlement or other disposition made by a person to his or her minor child or stepchild, it will trigger the effects of section 7(3) and be taxed accordingly.[137]

Section 7(3) is aimed at preventing income splitting between parents and their minor children.[138] By the application of this subsection, income produced by the asset subsequent to the donation of said asset will be deemed to be that of the donor and taxed accordingly.

The relevant section reads as follows:

> "Income shall be deemed to have been received by the parent of any minor child or stepchild, if by reason of any donation, settlement or other disposition made by that parent of that child—
>
> *(a)* it has been received by or has accrued to or in favour of that child or has been expended for the maintenance, education or benefit of that child; or
>
> *(b)* it has been accumulated for the benefit of that child."

Accordingly, where a father creates a trust for the benefit of his minor child, by donating assets to the trust, the father would be liable for tax on the income derived from those assets. This will be the position until the child becomes a major, notwithstanding the fact that the income had been received by or accrued to the minor or had been expended or accumulated for the child's benefit.

Even though section 7(3) is typically encountered in the context of *inter vivos* trusts, there is no reason why the subsection could not also apply to testamentary trusts. For example, it is possible that a parent of a minor child, who is the beneficiary of a testamentary trust created by the child's grandparent, could donate to said trust. In such case, the income generated by the donation, settlement, or other disposition,

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[135] De Koker & Williams *Silke on South African Income Tax* para 10.60 and 12.29.

[136] South African Revenue Services "Rates of Tax for Individuals" (undated) *SARS* <https://www.sars.gov.za/tax-rates/income-tax/rates-of-tax-for-individuals/> (accessed 2022-01-11).

[137] Honiball & Olivier *The Taxation of Trusts in South Africa* 85.

[138] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.

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which is subsequently distributed, accumulated or expended for the maintenance, education, or benefit of the minor beneficiary, will be taxed in the parent's hands.

Notwithstanding the aforesaid, there has emerged an exception to this rule. The exception is not codified, but rather developed from practise. SARS will usually not invoke section 7(3) when a farmer donates livestock to his minor children, where said donation forms part of or is in line with a well-established custom.[139] This means that the income generated from any progeny of the donated livestock or any produce derived from said livestock, which is subsequently sold, such as milk or wool, will be taxed in the hands of the minor child and not in that of the parent.

Although the ITA does not define the term minor, it is accepted that a minor will be a person who is unmarried and under eighteen years of age. Section 17 of the Children's Act 38 of 2005 changed the age of majority from 21 to age 18. For the purpose of the ITA, "child" includes an adopted child, and section 7(3) specifically refers to a stepchild.[140] Based on the normal interpretation rules, "child" will also extend to include both legitimate and illegitimate children in relation to the parents. However, grandchild is not included in the meaning of child in this context. This means that should a grandparent donate an income-producing asset to a minor grandchild, the income that arises from said asset will not be taxed in the hands of the grandparent by virtue of section 7(3), but the income will rather be taxed in the minor's hands in accordance with the normal income tax rates.

Section 7(3)(a) implies that the income arising from any donation, settlement or other disposition will be deemed to be that of the parent donor, if either the income has been expended on behalf of or in favour of the donor's minor child, or if the child has a vested right to said income.[141] The vested right does not mean that the minor child must receive the income directly in its hands, but merely that the child's entitlement to said income is unconditional. Section 7(3)(b) provides that the income that results from any donation, settlement or other disposition will be deemed to be that of the parent donor, where the income is accumulated for the benefit of the minor child.[142] In this case, it is not exactly clear what meaning should be assigned to the phrase "accumulated for the benefit of the minor child" nor what the ambit of the

[139] Para 17.3.6. De Koker & Williams *Silke on South African Income Tax* paras 10.60 and 12.29.
[140] Section 1 of the ITA "definition of child".
[141] Honiball & Olivier *The Taxation of Trusts in South Africa* 85.
[142] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.

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wording should be. Does it perhaps mean that the child must have a vested right to the income? Or does it require the parent to have formed an intention to benefit the minor child?

In *Platt v CIR* ("*Platt*")[143] the court considered the meaning of section 9(3)(b), which was the equivalent of today's section 7(3)(b). The court held that:

> "The language of 9(3*)(b)* implies purpose and intention. The words 'for the future benefit of his minor child' may, in my opinion, be paraphrased: 'for the purpose and with the intention that his minor child may in the future benefit'. If that is correct, that there must be purpose and intention, then there must be a person in whose mind the purpose and intention exist; and that person must be the parent who makes the donation or settlement. It cannot be anyone else. Now what the parent's purpose is in any particular case, must be ascertained from the terms of the instalment of donation or settlement and from relevant surrounding circumstances. Cases may be conceived where the question might be doubtful, e.g., where some benefit is indeed conferred on a minor child, but of a remotely contingent nature."[144]

Even though the old section 9(3)(b) was not identical to that of section 7(3)(b), it is submitted that the reasoning in the *Platt* case still applies. Section 9(3)(b) contained the word "future", but it was subsequently omitted from the new section 7(3)(b).

Based on the Platt case, it is evident that the intention of the parent in making the donation to the trust is the decisive factor. It is immaterial whether the child has a vested right to the income, or whether the child's entitlement to said income is contingent upon a future event, such as attaining the age of majority or getting married. In this context, it is possible that the exercise of the trustees' discretion under a discretionary trust can also constitute an event. However, this aspect is further discussed later in the chapter as part of the discussion of section 7(5).

The court further held that the possibility that the specified event may never come to fruition does not alter the donor's intention to benefit the minor child.[145] It is true that there is always the possibility that an envisaged event may not happen, and should that be the case, the child would not benefit. However, when the parent made the donation, it was after contemplation and with the expectation that the child will live to

[143] 1934 AD 552
[144] *Platt v CIR* 1934 AD 552 555.
[145] 556.

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reach, for example, majority.

The effect of the provision will continue until an event occurs that severs the causal link between the parent's donation and the income that is received by or that accrues to the minor child.[146] In other words, there is a limit to the period that the income can be attributed back to the donor parent. Section 7(3) specifically refers to "minor child". Once the child ceases to be a minor,[147] the provisions of section 7(3) can no longer apply.[148]

In addition, in the event that the donor parent dies, the provision will also cease to operate. However, if the donor parent is married in community of property, the income accruing to a minor child will be attributed to each of the parents by virtue of the gratuitous disposition from their joint estate.[149] This means that in the case that one of the parents dies, section 7(3) will continue to apply, but the attribution to the surviving parent will be limited to the proportionate amount, which will be half of the original attributable income.

5 2 2 3 Section 7(4)

While section 7(3) has the objective of preventing income splitting from occurring between the parent and the minor child,[150] the purpose of section 7(4) is to prevent the circumvention of the anti-avoidance rule in section 7(3) through the use of a third party.

The relevant section reads as follows:

> "Any income received by or accrued to or in favour of any minor child or stepchild of any person, by reason of any donation, settlement or other disposition made by any other person, shall be deemed to be the income of the parent of that child, if such parent or his or her spouse has made a donation, settlement or other disposition or given some other consideration in favour directly or indirectly of the said other person or his or her family."[151]

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[146] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[146] Para 17.3.6.
[147] Cronje & Heaton *SA Family Law* 49.
[148] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[149] Section 57A of the Act; s 14 of the *Matrimonial Property Act* 88 of 1984.
[150] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[151] Section 7(4) of the ITA.

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This provision is aimed at the instance where a parent makes a disposition involving an appreciable element of liberality or generosity to another person, or connected party to such person, in exchange for a donation to a trust which is created for the benefit of the former's minor child.[152] In such case, the income arising from said donation will be deemed that of the parent.

This can be illustrated by the following example. Suppose parent A donates R100 000 to a trust with the minor child of parent B as the only beneficiary. In turn, parent B also donates R100 000 to a trust which is created for the benefit of the minor child of parent A. Due to the working of section 7(4), the interest generated on the donated amount will not be taxed in the hands of the minor children, but will rather be deemed to be that of the parents. If it was not for section 7(4), the parents will have succeeded in avoiding the application of section 7(3). Hence, the interest portion would have been taxed in the minor's hands.

For this section to come into operation, there must be a certain degree of reciprocity present in the arrangement.[153] This means that there must be a causal connection between the act of the donor and the donation made by the third party. However, there does not have to be any correlation between the value of the donation, or the consideration given by each party. The provision cannot apply to the transaction if there is no reciprocity present.

In *COT v Paice,*[154] the court held that "There must be some causal connection between the disposition by the taxpayer to the other person, and the disposition by the other person which leads to income for the children." In addition, the court confirmed that the intervening third party could also be a company.[155]

5 2 2 4 Section 7(5)

Unlike section 7(3) and 7(4), which aims to prevent tax avoidance from occurring by means of income splitting, section 7(5) is designed to prevent a specific type of tax avoidance arrangement.[156]

Section 7(5) is a complex provision, with a number of inter-related components.

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[152] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[153] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[154] 25 SATC 385.
[155] *COT v Paice* 25 SATC 385.
[156] De Koker & Williams *Silke on South African Income Tax* para 12.29.

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The provision may apply to any person who has made a donation, settlement or other disposition but is typically encountered in conjunction with the use of trusts.

The relevant section reads as follows:

> "If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person."[157]

The exact scope and working of this provision are unclear. Various uncertainties regarding the circumstances under which it should be applied, and the interpretation of some of the key phrases remain unresolved.[158] The provision targets a situation where a person transfers assets to a trust, without due consideration received, but where the person makes the receipt of the income conditional.[159] In other words, the receipt of the income is postponed or restricted subject to the occurrence of a specific event. The result is that the income cannot immediately be distributed to the beneficiaries but will rather be accumulated until the conditions are fulfilled.[160] Such income is deemed to be that of the person who imposed the conditions, and will accordingly be taxed in said person's hands. This position will only cease to have effect on the death of the donor, or at the realisation of the event, whichever occurs first.[161]

The person to whom the income must be attributed, is the person who funded the trust by means of a donation or similar disposition.[162] The donor is not necessarily the same person as the original founder of the trust.[163] Consequently, if a trust has been created by a donor, who has made a withholding stipulation or condition in the

[157] Section 7(5) of the ITA.
[158] De Koker & Williams *Silke on South African Income Tax* para 12.29.
[159] Honiball & Olivier *The Taxation of Trusts in South Africa* 42.
[160] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[161] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[162] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[163] De Koker & Williams *Silke on South African Income Tax* para 12.29.

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trust deed, that original donor will only be liable to tax on the income that arise from his donation. Should a new donor make a further donation to the existing trust, the income derived from the new donation will be deemed to be the income of the new donor.

The fact that the provision uses the phrase "whether made or imposed by such person or anybody else", nullifies any claim that the trust is liable to tax on income, which is derived from a further donation made by a new donor to an existing trust, which still has the withholding stipulation from the original donor in place.[164] Thus, in such case, it is submitted that section 7(5) will apply and that the income that arises in consequence of the further donation, must be deemed to be that of the new donor and taxed accordingly in the new donor's hands. The income cannot be deemed to be that of the original donor, and neither is the trust liable for tax on it, even though the income may be accumulated in the trust.

The operation of the provision is limited to the income that arises from the donation, settlement or other disposition.[165] In the absence of the restriction imposed, said income would be received by or would accrue to either the beneficiaries or the trust. Hence, a causal link is required between the donation, settlement or disposition and the income which, but for the contemplated stipulation or condition, would have been derived by either the beneficiaries or the trust.[166]

This means that section 7(5) can only apply if the following questions are answered in the affirmative:

1. Did a donation, settlement or other disposition take place?
2. Is the income received by reason of the donation, settlement or other disposition?
3. Is the donation, settlement or other disposition subject to a stipulation or condition to the effect that the beneficiaries shall not receive the income or portion thereof until the happening of some event, whether fixed or contingent?
4. Is the person who made the donation, settlement or other disposition still alive?

Of the questions above, (1) and (2) have already been dealt with in paragraph 5 1 2 and will not be further discussed. However, the more problematic question that warrants further discussion is that contained in (3), which has given rise to many

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[164] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[165] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[166] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.

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difficulties, and the courts still have not arrived at a definitive answer nor provided consistent guidelines to deal with the problem.

5 2 2 4 1 The event

The dilemma revolves around the meaning of the word event used in the provision. It is thus unclear what type of event is covered by the provision, and even more troublesome, is whether the exercise of a trustee's discretion in terms of the provisions of a trust deed will constitute an event as contemplated in section 7(5).

It is well established that a provision in a trust deed that stipulates that the beneficiaries may not receive income from the trust until the attainment of a certain age, or death, or marriage, or some other clearly defined future occurrence will constitute an event and fall within the ambit of section 7(5).[167] But whether the word "event" in this context encompasses the exercise by the trustees of a discretion to distribute income to a trust beneficiary is debatable, and academic writers are divided on the issue.[168]

If one turns to the dictionary meaning of "event", the Oxford dictionary defines an event as: "a thing that happens, especially something important".[169] Similarly, the Cambridge dictionary defines event as: "anything that happens, especially something important or unusual".[170] Therefore, from a purely literal interpretation, there is no reason why the exercise of a trustee's discretion can not constitute an event. Neither is there anything in the provision that will justify limiting the generality of said meaning.

In *Hulett v CIR*,[171] the court found that the exercise of a trustee's discretion did in fact constitute an event. The court held the following:

> "As I interpret the document the beneficiaries are not entitled to claim payment of income as of right. They receive it – or such part of it as the trustees choose to give them – if the

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[167] De Koker & Williams *Silke on South African Income Tax* para 12.29.

[168] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7; Davis, Beneke & Jooste Estate Planning para 6.3; De Koker & Williams *Silke on South African Income Tax* para 12.29; Clegg & Stretch *Income Tax in South Africa* para 17.3.6; D Meyerowitz *Meyerowitz on Income Tax* (2008).
PA Olivier, S Strydom & GPJ van den Berg *Trust Law and Practice Service* Issue 3 (November 2011).

[169] Oxford Learner's Dictionaries "Event" (undated) *Oxford Learner's Dictionaries* <https://www.oxfordlearnersdictionaries.com/definition/english/event> (accessed 2021-12-21).

[170] Oxford Learner's Dictionaries "Event" (undated) *Oxford Learner's Dictionaries*.

[171] 1944 NPD 263.

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trustees in their absolute discretion decide to pay it over. Thus, their rights are contingent until the happening of the event, viz. the exercise by the trustees of their discretion."[172]

In *Berold,*[173] it was argued that the exercise of a discretion by the trustees whether or not to pay income to the beneficiaries does not constitute an event as contemplated in the provision. It was contended that the event intended by the legislature was one that altered the incidence of tax.[174] It was submitted that the exercise of a trustee's discretion could not be regarded as an event that gives rise to a change in taxation.[175] It was further submitted that such discretion can only be made with respect to income already accrued, which would be deemed to be that of the donor.[176] Hence, the exercise of the trustees' discretion on whether to distribute income to the beneficiaries cannot be regarded as an event. Unfortunately, the court did not make a ruling on this point. However, a similar argument was raised in *ITC 1033*[177] but was subsequently rejected. The court held that the word "event" is one of wide significance. Its ambit is further increased by the addition of the phrase "whether fixed or contingent".[178]

In *Estate Dempers v SIR*,[179] the court was once again faced with the question of whether the exercise by a trustee of a discretionary power should be regarded as an event. The argument was raised that the kind of event intended is one of a single, once-and-for-all occurrence.[180] Such occurrence must result in breaking the fiction, where the income is deemed to be that of the donor.[181] Unfortunately, the court did not use this opportunity to make a decisive ruling on this point. However, some support was expressed for the arguments presented to the court, which held that such an exercise of a discretion by a trustee is not an event for purpose of the equivalent to today's section 7(5).[182]

It was further contended that should the exercise of a trustee's discretion constitute an event this will give rise to various anomalies. *Inter alia*, the situation

[172] *Hulett v CIR* 1944 NPD 263.
[173] 1962 3 SA 748 (A).
[174] *CIR v Berold* 1962 3 SA 748 (A) 457.
[175] 458.
[176] 459.
[177] (1959) 26 SATC 73.
[178] *ITC 1033* (1959) 26 SATC 73.
[179] 1977 3 SA 410 (A).
[180] *ITC 1033* (1959) 26 SATC 73.
[181] *ITC 1033* (1959) 26 SATC 73.
[182] *Estate Dempers v SIR* 1977 3 SA 410 (A).

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where income that accrued to a trust during the year of assessment would be deemed to be that of the donor even if at the end of the year, the trustee elects to pay all the income to the beneficiaries, notwithstanding the fact, that the purpose of section 7(5) is to tax trust income in the hands of the donor, only to the extent that said income is not received by the beneficiaries.[183]

Following the reasoning above, should the exercise of such a discretion be regarded as an event, once the trustee exercised said discretion, the liability of the donor would cease, regardless of whether the decision exercised was to distribute income to the beneficiaries, or whether the trustee elected to rather retain the income in the trust. If this interpretation is true, it means that the section will be invoked once the trustee exercises a decision, and not only when income is distributed to the beneficiaries. Thus, it is submitted that if the exercise of a trustee's discretion is indeed found to be an event, the event contemplated by the provision is limited to one that vests the income in the hands of the beneficiaries.

According to *Meyerowitz* the aforesaid anomalies can be resolved if the phrase in section 7(5) "shall not receive" should rather be interpreted to mean "shall not be entitled to demand".[184] However, it is unclear if the resulting anomalies are sufficient to depart from the literal meaning of "receive".

The court in *Estate Dempers* described the requirements as follows: "In truth the application of the devolutionary portion of the subsection involves a hypothetical, notional enquiry which cannot be directed solely to questions such as whether the beneficiary's right to income is vested or contingent. The question that the court must ask itself is whether this income would have been received by or have accrued to the beneficiary in the absence of the stipulation withholding trust income. In answering this question regard must be had to the terms of the instrument generally, the donor's general benevolent intention, as evinced by the terms of the instrument, and all the relevant circumstances. In this enquiry the fact that in terms of the instrument as a whole the beneficiary has a vested right to the income would, as I have indicated, be an important factor but it would not be the sole touchstone".[185]

It is submitted that the above passage in *Estate Dempers*[186] means that section

[183] *ITC 1033* (1959) 26 SATC 73.
[184] Meyerowitz *Meyerowitz on Income Tax* (2008).
[185] *ITC 1033* (1959) 26 SATC 73.
[186] *Estate Dempers v SIR* 1977 (3) SA 410 (A) 614.

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7(5) operates on the premise that there is a stipulation that prohibits the beneficiary from receiving the trust income until the occurrence of a specified event. In addition, the provision provides that there is a deemed transfer from the beneficiary back to the donor until the event takes place. This so-called devolution attributes the income back to the donor; if it were not for the stipulation, said income would be received by or accrue to the beneficiary concerned.

Olivier contends that it is not clear why the court in *Estate Dempers*[187] found it necessary to enter into a "hypothetical, notional inquiry". He claims that the inquiry was completely unnecessary to bring the facts of the case within the ambit of the provision.[188] He further criticises the so-called "subjective approach" adopted by the court in the *Estate Dempers*[189] case. In conclusion Olivier warns that it may be possible for a taxpayer to argue that it was not the dominant objective to benefit a particular beneficiary.[190] Hence, the application of the "hypothetical, notional inquiry" could lead to an unintended result.

There is further no basis to suggest that the application of section 7(5) will result in double taxation, since once the accumulated income is deemed to be that of the donor, it cannot subsequently accrue as income to the beneficiary when said income is distributed.[191]

In *SIR v Sidley*[192] the court held that the true event is the attainment of a specified age by the beneficiary. Notwithstanding, it was still subject to the trustees' discretion to withhold the income. Therefore, section 7(5) was applicable. This points to the acceptance that such discretion may constitute an event. However, for clarity on this matter, one would have to wait until such time that the courts make a decisive ruling on this question.

Academic authors still have conflicting views on this point. For one, Olivier is of the opinion that the exercise of a trustee's discretion is an event.[193] He justifies this by stating that it is in accordance with SARS's practice as illustrated in the case of *Estate*

[187] 615.
[188] Olivier, Strydom & Van den Berg *Trust Law and Practice Service*.
[189] *Estate Dempers v SIR* 1977 (3) SA 410 (A).
[190] Olivier, Strydom & Van den Berg *Trust Law and Practice Service*.
[191] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[192] 1977 4 SA 913 (A).
[193] Olivier, Strydom & Van den Berg *Trust Law and Practice Service*.

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Dempers[194] where the beneficiaries were taxed on income distributed to them.[195] In that case, the trustees had exercised their discretion, giving rise to the event, and accordingly section 7(5) fell away resulting in the income being taxed in the hands of the beneficiaries. However, De Koker and Williams seems to disagree with this interpretation.[196] Their view is *inter alia* based on the notion that an event must be something which determines the incidence of tax once and for all in respect of the relevant income. It is held that the trustees' decisions from time to time cannot achieve this.

In *Natal Joint Municipal Pension Fund v Endumeni Municipality* ("*Natal Joint Municipal Pension Fund*")[197] the court criticised the incoherent approach to statutory interpretation. The court further held that ascertaining the legislator's intension is nothing more than a misnomer and should be abandoned.[198]

Instead, the court described the process of interpretation as follows:

> "Interpretation is the process of attributing meaning to the words used in a document, … having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible ... results or undermines the apparent purpose of the document. ... [B]e alert to, and guard against, the temptation to substitute what [you] regard as reasonable [or] sensible for the words actually used [for] to do so is to cross the divide between interpretation and [divination]. ... The 'inevitable point of departure is the language ... itself, read in context and having regard to [its] purpose ... and the background to the preparation and production of the document".[199]

[194] *Estate Dempers v SIR* 1977 (3) SA 410 (A) 615.
[195] Olivier, Strydom & Van den Berg *Trust Law and Practice Service*.
[196] De Koker & Williams *Silke on South African Income Tax* para 12.29.
[197] 2012 4 SA 593 (SCA) 17.
[198] *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 4 SA 593 (SCA) para 25.
[199] Para 18.

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Based on the above passage from the *Natal Joint Municipal Pension Fund*[200] case, one can infer that text and context go together in the process of interpretation; that one starts with the language and the rules of grammar and syntax, but always viewed in the light of the context, the apparent purpose of the document and, where there is relevant knowledge, the material known to those responsible for its coming into existence. However, the meaning of the words and the context in which it occurs can only be derived from the actual text and available evidence. One cannot base the context on subjective considerations.

In addition, it is required that judges articulate their reasons, both linguistic and contextual, for arriving at their decisions on questions of the construction of documents.[201] Only if judges explain the contextual material on which they rely, will it be possible to assess whether that reliance is legitimate or unjustified.

In the same case, the court found that it is desirable to have a single reasonably clear standard for the interpretation of documents that enables lawyers and courts to go about their business of interpreting documents, without becoming bogged down in the "how" of interpretation.[202] Hence, there is no need for separate approaches to different types of documents.

In light of the above discussion, and the principles outlined in the *Natal Joint Municipal Pension Fund* case, it is submitted that a discretion by trustees' does not constitute an event for purposes of section 7(5). Aside from the fact that the *Estate Dempers*[203] case alluded to such, if one considers the meaning of event in the context of taxation, an event must be final, which the exercise of a discretion is not. If one interprets it as such, it results in anomalies, which is in contrast with the objective of the provision. For one to rectify the anomalies, one will have to go beyond mere interpretation, but instead venture into the sphere of drafting. The aforementioned factors are strong indicators that within the linguistic and contextual boundaries of the provision, it cannot be said that an exercise of the trustees' discretion is an event.

5 2 2 4 2 Vested rights

A further aspect of section 7(5) is the provision that, but for the stipulation, the income

[200] 2012 4 SA 593 (SCA) 18.
[201] *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 4 SA 593 (SCA) 19.
[202] 20-21.
[203] *Estate Dempers v SIR* 1977 3 SA 410 (A).

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would be received by or accrued to the beneficiaries. This raises the question whether section 7(5) will only apply if the beneficiaries have vested rights to the accumulated income, or whether it also applies where there are no vested rights.[204]

In *Estate Dempers v SIR*[205] the court stated the following:

> "A vested right to the accumulated income is not a *sine qua non*. Naturally, if the beneficiaries have vested rights, then this would be a strong, possibly decisive, factor leading to the conclusion that, but for the stipulation withholding the income, it would have been received by them".[206]

The court further held that the provision is not limited to beneficiaries with vested rights.[207] On this point, the court explained that the use of the words "fixed or contingent", denotes the event that must take place before the beneficiary is allowed to receive the income.[208]

This means that if the beneficiary is not to receive the income until the happening of a contingent event, the beneficiary's right to that income will also be contingent. Differently put, the right to the income is uncertain or conditional. Therefore, said income cannot vest in the beneficiary.

The *Estate Dempers*[209] case seems to suggest that one must inquire for whose benefit the income is primarily being accumulated. In other words, vesting is not essential. The court further held that one must consider the terms of the trust deed, the donor's intension, and all the facts and circumstances of the specific case.[210]

In practice, one finds that SARS always invokes section 7(5), if there is a provision in the trust deed that provides that the trust income must be withheld.[211] This is regardless of whether the beneficiaries have a vested right to said income, or merely a contingent right. It is further immaterial whether the beneficiaries' right to the trust income is subject to the trustee's exercising their discretion.

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[204] B van der Merwe "The meaning and relevance of the phrase vested right in income tax law" (2000) 12 *SA Merc LJ* 320.
[205] 1977 3 SA 410 (A).
[206] *ITC 1033* (1959) 26 SATC 73.
[207] *ITC 1033* (1959) 26 SATC 73.
[208] *ITC 1033* (1959) 26 SATC 73.
[209] *Estate Dempers v SIR* 1977 3 SA 410 (A).
[210] *ITC 1033* (1959) 26 SATC 73.
[211] De Koker & Williams *Silke on South African Income Tax* para 12.29.

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In the instance that the trustees exercise their discretionary powers to distribute any of the trust income to the beneficiaries, it is the practice to subject the beneficiaries to tax on the income distributed, while applying section 7(5) to the undistributed income.[212] This means that the donor will be subjected to tax on the undistributed income.

Based on the above, it would seem that where a trust deed does vest income in a beneficiary but withholds its receipt until the happening of a specified event, section 7(5) would certainly apply. However, this does not always seem to be the position adopted by the courts. In a number of Special Court decisions, the opposite was held to be true. In *ITC 775,*[213] the court indicated that section 7(5) was not applicable if the beneficiaries acquired only a contingent interest to the trust's income. In such a case, the income will be taxable in the hands of the trust. In *ITC 823*,[214] the court came to the opposite conclusion based on similar facts.

In the Unreported Case 5781, the court found that:

> "It seems to me that if the beneficiary has a vested right to the income at the time of its receipt by the trustees the income could be treated as taxable in the hands of the beneficiary in which event it would not be taxable in the hands of the trustees or donor."

Similarly, the court followed the same line of reasoning in *ITC 903*. It should be noted that the aforementioned cases preceded that of *Estate Dempers*.[215]

Notwithstanding the aforesaid, in *ITC 1328*, which was delivered subsequent to the judgment in *Estate Dempers*,[216] the court accepted the reasoning in the Special Court cases discussed above. The court held that all income not paid to the beneficiary was taxable in the hands of the beneficiary in terms of section 7(1), and therefore section 7(5) did not apply.

For the above judgment to be correct, one would have to accept the notion that section 7(1) takes precedence over section 7(5). It is not clear what the purpose of section 7(1) is supposed to be. At the most, it seems to emphasise the principle of accrual. One can therefore infer that it merely reinforces the idea that income not

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[212] Clegg & Stretch *Income Tax in South Africa* para 17.3.1.
[213] 10 SATC 314.
[214] 21 SATC 77.
[215] *Estate Dempers v SIR* 1977 (3) SA 410 (A).
[216] 621.

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received by a taxpayer in the year it accrues will still be taxed in the beneficiary's hands in that year of assessment. If one assigned a wider meaning to this provision, it would result in a conflict between section 7(1) and 7(5).

The problem arises in the context of undistributed income. This is typically encountered where a trust beneficiary has a vested right in terms of the trust, and which is not distributed to the beneficiary due to the non-occurrence of the stipulated event. In such case, in terms of section 7(1) the income would be taxable in the hands of the beneficiary, but in terms of section 7(5), the income would be deemed to be taxable in the hands of the donor.[217]

Olivier seems to agree that where a beneficiary has a vested right to income, which has been accumulated in the trust, such income is taxable in the hands of the beneficiary.[218] This conclusion is reached by virtue of the provision contained in section 7(1). However, a number of authors dispute the accuracy of the aforesaid. According to Swersky, section 7(5) is clear that if the beneficiary is not to receive the income before the happening of an event, as much of the income as would have been received by, or accrued to said beneficiary, will be deemed to be the donor's income.[219] This view hinges on the premise that section 7(5) ought to prevail over section 7(1), in line with the trite principle that a specific provision takes precedence over a general provision, and that the precise meaning of section 7(1) is obscure. De Koker and Williams seem to concur with this view.[220] It is submitted that the aforesaid interpretation is the most suited, and hence, preferred over the argument presented by Olivier.

5 2 2 4 3 The meaning of income

Another controversial matter is the question pertaining to the correct definition and interpretation of "income". As was seen with the other key phrases, academic authors are divided on the subject.[221] According to De Koker and Williams, the "income"

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[217] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[218] Olivier, Strydom & Van den Berg *Trust Law and Practice Service*.
[219] C Swersky "Vested and contingent rights and section 7(5)" (1981) *Income Tax Reporter* 252.
[220] De Koker & Williams *Silke on South African Income Tax* para 12.29.
[221] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7; Davis, Beneke & Jooste *Estate Planning* para 6.3; De Koker & Williams *Silke on South African Income Tax* paras 12.19 and 12.21; Clegg & Stretch *Income Tax in South Africa* para 17.3.6; D Meyerowitz *Meyerowitz on Income Tax* (2008); PA Olivier, S Strydom & GPJ Van den Berg *Trust Law and Practice Service*; Jooste (2002) *Acta Juridica* 186.

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referred to in section 7(5) does not mean "amount", nor does it mean "profits" or "gains", which is the view adopted by SARS. Honiball and Olivier concur with De Koker but are of the opinion that "income" should be assigned its normal meaning as contained in section 1 of the ITA.[222] Mazansky seems to support the interpretation postulated by SARS.[223]

If one adopts an interpretation that equates income with net profit, or put differently, total earnings less total expenditure, one runs the risk of undermining the effectivity of section 7(5). Nevertheless, if one follows the meaning postulated by Honiball and Olivier, which advocates for an interpretation that the word income should have the meaning ascribed to it in section 1 of the ITA,[224] it would give rise to an inequitable situation. In such construction, income would mean gross income less exempt income. If this definition is followed, it will mean that it is not possible to deduct any of the trust's expenses incurred. Hence, the donor will be taxed on an amount that is potentially much larger than the amount that the beneficiary will receive once the restrictive stipulation has laps.

In the context of section 7(5), De Koker and Williams suggest that the better interpretation of the word "income" should rather be gross income, less related deductible expenditure and losses.[225] If one accepts this view, it follows that the amount deemed to be the income of the donor would be the gross income received by the trust less related deductible expenditure and losses. In such construction, the result will be that the donor gets taxed on a similar amount that the beneficiaries will receive once the prohibitive stipulations are fulfilled.

Clegg contends that the word income in section 7(5) must rather be understood as an amount, which is in line with the wording used in section 7(8).[226] It appears that Clegg is not the only author who advocates for this interpretation, but Oliver has also expressed support for the aforesaid.[227] Jooste also seems to concur with this view but cautions that in such a case there is no provision made to utilise the deductions and allowances that would have been available to the taxpayer.[228] Without affording the

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[222] Honiball & Olivier *The Taxation of Trusts in South Africa* 85-86
[223] Meyerowitz *Meyerowitz on Income Tax* (2008).
[224] Honiball & Olivier *The Taxation of Trusts in South Africa* 86.
[225] De Koker & Williams *Silke on South African Income Tax* para and 12.21.
[226] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[227] Olivier, Strydom & Van den Berg *Trust Law and Practice Service*.
[228] Jooste (2002) *Acta Juridica* 186-187.

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taxpayer the opportunity to reduce the accrued income by applying the deductions and allowances, will result in the taxpayer being taxed on the gross income, which is inequitable. For non-resident trusts, such interpretation would significantly expand the ambit of the income subject to section 7(5). If this view is accepted, it means that the income contemplated in section 7(5), will go beyond only South African source income and taxable foreign dividends, but will then extend to include all foreign income.

However, this view is not convincing. While the legislator opted to change the wording in sections 25B(2A) and 7(8) to read "amount" and no longer income, the same was not the case for section 7(5). Similarly, section 7(8) also made provision for deducting relevant expenses from the income received by or accrued to the non-resident trust.[229] In the case of section 7(5), the omission indicates that the legislator did not intend that income should be assigned the meaning of amount.

In *Commissioner for Inland Revenue v Simpson* ("*Simpson*"),[230] the question revolved around the meaning of income in the context of the foregoing provision of today's section 7(2). The court held that the word "income" had to be construed as meaning the accrued profits and gains and not as gross income less exempt income as it is defined.[231]

If the interpretation in the *Simpson* case is adopted, it may result in a highly unfair outcome for the taxpayer. Unless one crudely circumvents this problem by understanding the notion of profits or gains to imply that expenditures are, in any case, deducted in arriving at the profit or gain. Although this formulation is a workable solution, it is submitted that it is unsatisfactory and hence, is not to be preferred. However, it appears that this is the approach followed by SARS.[232]

Notwithstanding the aforementioned, it may be permissible to depart from a defined term when interpreting legislation under certain circumstances. To this extent, in the case of *Simpson,* the court held that:

> "it seems to me that effect should be given to the rule laid down by Halsbury, Laws of England, in para. 591 of Vol. 31 (Hailsham ed.), viz.:

[229] Section 7(8) of the ITA.
[230] 1949 4 SA 678 (A) 692.
[231] *Commissioner for Inland Revenue v Simpson* 1949 4 SA 678 (A) 692.
[232] Davis, Beneke & Jooste Estate Planning para 6.4.

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> 'A definition section does not necessarily apply in all the possible contexts in which a word may be found in the statute. If a defined expression is used in a context which the definition will not fit, it may be interpreted according to its ordinary meaning.'"[233]

In *Canca v Mount Frere Municipality* ("*Canca*")[234] the court stated that:

> "The principle which emerges is that the statutory definition should prevail unless it appears that the Legislature intended otherwise and, in deciding whether the Legislature so intended, the Court has generally asked itself whether the application of the statutory definition would result in such injustice or incongruity or absurdity as to lead to the conclusion that the Legislature could never have intended the statutory definition to apply".[235]

In *Hoban v ABSA Bank Ltd t/a United Bank* ("*Hoban*"),[236] the court followed the reasoning in the *Canca*[237] case, but added that the legislative intention must be ascertained when analysing the context.[238] Furthermore, the court explained that the context should not be limited to parts of a legislative provision, which immediately precede and follow the specific passage under examination, but rather extends to include the entire enactment in which the word appears, and in its widest sense also enactments in *pari materia* and the situation sought to be remedied.[239]

Although various academic authors have proposed the interpretation that should be followed for the word income, there are still deficiencies. Aside from the definition of income in section 1 of the ITA, the term income is not defined in the context of section 7(5). In terms of the *Canca*[240] case, it is accepted that, as a general rule, the statutory definition must be used, unless such interpretation will result in an unforeseen outcome. Following from the *Simpson* case, in such instance, it may be appropriate to deviate from the definition in the ITA, and rather adopt the ordinary meaning of the word.

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233 *Commissioner for Inland Revenue v Simpson* 1949 4 SA 678 (A) 692.
234 1984 2 SA 830 (Tk).
235 *Canca v Mount Frere Municipality* 1984 2 SA 830 (Tk).
236 1999 2 SA 1036 (SCA) 1044.
237 *Canca v Mount Frere Municipality* 1984 2 SA 830 (Tk).
238 *Hoban v ABSA Bank Ltd t/a United Bank* 1999 2 SA 1036 (SCA) 1044.
239 1044.
240 *Canca v Mount Frere Municipality* 1984 2 SA 830 (Tk).

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According to the Oxford dictionary, the word income can be defined as: "the money that a person, a region, a country, etc. earns from work, from investing money, from business, etc."[241] Similarly, the Cambridge dictionary defines income as: "money that is earned from doing work or received from investments".[242]

The dictionary meaning of income appears to refer to gross income. In other words, in the normal sense of the word, no provision is made for any deductions. However, in the context of section 7(5), it is submitted that such interpretation cannot be correct. Should this meaning be used, it will result in an inequitable outcome.

In light of the principles outlined in the cases discussed above, and confirmed in the *Hoban*[243] case, it is submitted that the meaning of income put forward by De Koker and Williams is preferred. By equating income to mean gross income less related deductible expenditure and losses, one can avoid any possible injustice to the taxpayer without undermining the effectiveness of the provision. One should also recognise that the purpose of the anti-avoidance provision is not punitive in nature, but rather to ensure that the income is taxed at the taxpayer's marginal tax rate. This interpretation is also most aligned with the ordinary dictionary meaning of income, but also considers the context and basic principles of taxation.

Aside from quantifying the income that will be deemed to be that of the donor, the interpretation followed will also determine whether section 7(5) will apply to non-resident trusts or not. In this context, the income referred to in the provision is the income that is received by or accrues to the non-resident trust. If one follows the interpretation suggested by Honiball and Olivier,[244] that income should bear its defined meaning in section 1 of the ITA, section 7(5) would not apply to a situation where donations are made to non-resident trusts. This is due to the fact that non-resident trusts are non-residents, and hence, the income received by or that accrues to the non-resident trust, will not qualify as gross income, unless such income was from a South African source. But if any of the other proposed interpretations are used, section 7(5) will equally apply to non-resident trusts. Thus, it is submitted that De Koker and Williams's construction is preferred. It should be observed that if all the requirements

[241] Oxford Learner's Dictionaries "Income" (undated) *Oxford Learner's Dictionaries* <https://www.oxfordlearnersdictionaries.com/definition/english/income> (accessed 2021-12-22).

[242] Cambridge Dictionary "income" (undated) *Cambridge Dictionary* <https://dictionary.cambridge.org/dictionary/english/income> (accessed 2021-12-22).

[243] *Hoban v ABSA Bank Ltd t/a United Bank* 1999 2 SA 1036 (SCA) 1044.

[244] Honiball & Olivier *The Taxation of Trusts in South Africa* 85

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of section 7(5) are not satisfied, but the beneficiary is a minor child of the donor, section 7(3) or section 7(4) may apply.

If the donor dies, the operation of section 7(5) will cease to apply, but whether the restrictive stipulation will fall away or not will depend on the terms of the instrument.[245] If the instrument provides that the stipulation or condition will indeed laps at the death of the donor, under such circumstances, the income will be taxed in terms of section 25B, either in the hands of the beneficiary or the trust. Furthermore, if a donor is taxed in terms of section 7(5), the donor is entitled to recover the tax payable from the trustees.[246]

In summary, it is submitted that section 7(5) contains various ambiguous terms, which promotes uncertainty and enhances the complexity of the provision. To this extent, it is submitted that an amendment is required to address the aforesaid aspects and to clarify the provision's ambit. It is further submitted that section 7(5) can apply to different donors, even if the donations are made to the same trust. In such a case, each donor will only be liable to tax on the income that arises from his donation. Pertaining to the meaning of event, it is submitted that an exercise of the trustees' discretion is not an event for purposes of section 7(5). Moreover, it is submitted that section 7(5) can apply to both vested and contingent rights. The working of section 7(5) will also take precedence over that of section 7(1).

In the context of section 7(5), it is submitted that the word income should be understood to mean gross income less related deductible expenditure and losses and not the defined meaning of income. Closely related, section 7(5) can equally apply to residents and non-residents a like.

5 2 2 5 Section 7(6)

Whereas section 7(5) targets a situation where a donor transfers assets to a trust, but limits the beneficiaries' receipt of the income until the realisation of a specified event, section 7(6) is aimed at the situation where a donor disposes of his income-producing assets to a trust, but reserves the right to unilaterally revoke the donation or to confer the benefits of said donation upon someone else.[247]

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[245] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[246] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[247] De Koker & Williams *Silke on South African Income Tax* para 12.30.

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The relevant section reads as follows:

> "If any deed of donation, settlement or other disposition contains any stipulation that the right to receive any income thereby conferred may, under powers retained by the person by whom that right is conferred, be revoked or conferred upon another, so much of any income as in consequence of the donation, settlement or other disposition is received by or accrues to or in favour of the person on whom that right is conferred, shall be deemed to be the income of the person by whom it is conferred, so long as he retains those powers."[248]

The provision contemplates a situation where a deed of donation contains an express clause that reserves the right in favour of the donor to revoke the right granted or to confer it upon another.[249] This means that an act of revocation by the donor is envisaged in the provision. Should the donor invoke said right, it will result in the recipient of the subject matter being deprived of the benefit or cause a transfer to take place from the original intended beneficiary to the newly nominated beneficiary.[250]

This means that section 7(6) is applicable in the instance where a person donates assets to a trust for the benefit of specified beneficiaries, subject to the condition that the donor is entitled, at any stage, to revoke any of the beneficiaries' right to receive the income or is also free to confer the right to receive the income on any other person. Under these circumstances, for the duration that the donor retains these powers, all income received by or accrued to the specified beneficiaries is deemed to be that of the donor and thus, taxed in the donor's hands.[251]

The operation of this provision is limited to a beneficiary who has a vested right to the trust's income, subject to the donor's right of revocation.[252] Hence section 7(6) will not be applicable if a beneficiary merely has a contingent right to the income in the trust, which is subsequently derived from the donated asset, or where the receipt of said income is subject to the trustee's discretion, even though in such case, the donor has the express right to revoke or confer the benefit. However, in such circumstances, section 7(5) may apply and thus deem the income to be that of the donor.

[248] Section 7(6) of the ITA.
[249] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[250] Honiball & Olivier *The Taxation of Trusts in South Africa* 92.
[251] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[252] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.

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In the instance that a trustee is simultaneously the donor and requires the authority of the other trustees to revoke, the provision cannot be relied on. However, if the donor has the binding vote in all decisions, including the decision to revoke a benefit conferred, or to award said benefit to someone else without the approval of the other trustees, the provision will apply.

In *ITC 673*, the court held that the right to revoke granted to the donor must be expressly reserved. In the absence of such a right the provision cannot apply. However, the correctness of this judgment is questionable. According to De Koker and Williams, the court's proposition reaches too far, and there is no such limitation in the provision.[253] Meyerowitz concurs with this view and contends that aside from such an express right, it is also plausible for a trust deed to contain an implied right of revocation.[254] It is submitted that section 7(6) will apply if the donor can revoke or confer a benefit without the approval of another person, regardless of whether the trust deed explicitly contains such provision or whether the same result can be achieved indirectly.

The provision does not require that the right of revocation reserved in favour of the donor must actually be exercised.[255] It is sufficient if the donor is vested with the power to do so, and if the exercise of the power would result in the diversion of the income to other beneficiaries or it being accumulated in the trust.

The application of section 7(6) does not invalidate a trust deed that contains such express right of revocation in favour of the donor, but does nullify any income tax benefit that the founder may have obtained by creating the trust.[256] In addition, as a consequence of the founder retaining direct control over the trust's assets, it may also result in adverse estate duty liability.[257]

As with the other subsections of section 7, the operation of the provision will only cease at the death of the donor. This means that the income arising from the donation will be deemed to be that of the donor until the donor dies.[258] The only other circumstances that will result in the provision to terminate is if the trust deed is

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[253] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[254] Meyerowitz *Meyerowitz on Income Tax* (2008).
[255] Honiball & Olivier *The Taxation of Trusts in South Africa* 92.
[256] De Koker & Williams *Silke on South African Income Tax* para 12.30.
[257] M Botha, R King, L van Vuuren & W van der Westhuizen *Estate Planning and Fiduciary Services Guide* 119.
[258] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.

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amended beforehand to remove the provision or clause that grants the donor the right of revocation.[259]

5 2 2 6 Section 7(8)

While the other anti-avoidance provisions of section 7 predominantly focus on tax minimisation arrangements among South African residents,[260] section 7(8) is aimed at curbing transactions to non-residents who attempt to reduce the resident donor's tax liability by transferring income-producing assets to the non-resident.[261]

The relevant section reads as follows:

> "(a) Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition.
>
> (b) So much of any expenditure, allowance or loss incurred by the person contemplated in paragraph (a) as does not exceed the amount included in the income of the resident in terms of that paragraph and which would be allowable as a deduction under this Act in the determination of the taxable income derived from that amount had that person been a resident, is deemed to be an expenditure, allowance or loss incurred by that resident for purposes of the determination of the taxable income of that resident from that amount".[262]

The objective of section 7(8) is to prevent or to limit taxpayers from using offshore structures for tax avoidance arrangements. Such arrangements can take various forms but will typically entail taxpayers to divest income-producing assets from their personal capacity to an offshore trust structure. Other permutations are also possible, whereby the taxpayer's remuneration for services rendered is diverted to the offshore

[259] Para 17.3.6.
[260] Olivier & Honiball *International Tax: A South African Perspective* 571.
[261] Clegg & Stretch *Income Tax in South Africa* para 17.3.7.
[262] Section 7(8) of the ITA.

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trust, but such schemes are outside the ambit of section 7(8). If such asset transfer arrangements are successful, it will not only deprive SARS of income tax but will also have negative implications for other forms of tax collection in South Africa.

The provision targets the situation where South African residents transfer income-producing properties to non-residents without receiving due consideration for said asset. The arrangement or transaction must involve an appreciable element of liberality or generosity for the provision to apply.[263] In such case, the income that arises from the donation will be deemed to be that of the resident donor and will be taxed accordingly in the donor's hands, provided that all the other requirements of the provision are satisfied.

This subsection applies to all non-residents, provided such income arose because of or in consequence of any donation by a resident.[264] This means that the provision is not limited to natural persons, but rather extends to individuals, companies, trusts, foundations and incorporated partnerships.[265] The working of the provision will even apply if a configuration of various legal entities is used.

The operation of section 7(8) is often encountered where South African residents use non-resident trusts to minimise their tax liability in the Republic.[266] In such instances, a typical scenario can take the following form. Suppose a South African resident makes a donation to an offshore trust which is created for the benefit of the donor's family, which are all over the age of majority. Pursuant to the discretionary powers conferred on the trustees, they may apply the income of the trust for the benefit and enjoyment of the beneficiaries. In line with the provision, any amount generated as a result of, or that can be attributed to the original donation, will be taxable in the resident donor's hands, if such amount would have constituted income had the non-resident trust been a South African resident.[267] In addition to the income that will be deemed to be that of the donor, the donor will also be liable for donations tax on the donation. The only qualification is that upon distribution by the trust, the tax liability for the resident beneficiaries is restricted to only that portion that has not previously been subjected to tax in the Republic.[268]

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[263] De Koker & Williams *Silke on South African Income Tax* paras 12.28 and 12.31.
[264] Clegg & Stretch *Income Tax in South Africa* para 17.3.7.
[265] Honiball & Olivier *The Taxation of Trusts in South Africa* 94.
[266] Olivier & Honiball *International Tax: A South African Perspective* 571.
[267] Davis et al *Juta's Commentary on Income Tax*, Commentary on s 7.
[268] De Koker & Williams *Silke on South African Income Tax* paras 12.28 and 12.31.

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This can be best illustrated by way of an example. Suppose taxpayer A donates R1 000 000 to a non-resident trust. The trustees elect to invest the capital donation in an interest-bearing account that delivers a 10% return per annum. After the first year, the proceeds of the investment are R100 000. Assuming that the total amount is reinvested and subsequently produces a return of R110 000 in the following year. The resulting effect is that taxpayer A will be taxed on the proceeds from both year 1 and year 2. This is because the income can still be directly attributed to the initial donation. Put differently, if it was not for the original donation, there would have been no subsequent income. One could therefore describe the interaction, or the nature of the relationship, as a causal link between the donation and the generated income.

This occurrence will continue until the accumulated income is ultimately distributed to the beneficiaries by the non-resident trust. At that stage, it will be taxable in the hands of any resident beneficiaries, in the specific year of assessment, in terms of section 25B(2A) of the ITA, but only to the extent that such income has not been subjected to tax in the Republic in prior years.[269] In other words, if an amount is taxed in terms of section 7(8), section 25b(2A) does not apply.[270]

However, if the trustees instead resolve to use the capital donation to buy 15% shares in foreign company X and 20% shares in South African company Y, the dividend income that arises from the shares can no longer be attributed to the resident donor. Due to the exemptions available to resident taxpayers, said amounts will not constitute income in South Africa.[271] Hence, because the amounts would not have constituted income, the provision cannot apply and, therefore, the dividend income will not be taxed in the resident's hands.

Following the example above, suppose foreign company X declares a dividend of R80 000, and South African company Y declares a dividend of R70 000 at the end of the financial year respectively. In such case, the South African dividends will be regarded as exempt income and the application of the participation exemption will equally result in the foreign dividends being excluded from the taxable income of the resident donor. Thus, section 7(8) cannot apply to the resulting dividend income, nor can said amounts be taxed in the resident donor's hands.

This means that amounts that would have qualified for exemptions if they were

[269] Section 25B(2A) of the ITA.
[270] De Koker & Williams *Silke on South African Income Tax* paras 12.28 and 12.31.
[271] Paras 12.28 and 12.31.

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received by or accrued to residents will still not constitute income if it is received by the non-resident trust.[272] Similarly, income that would have constituted exempt income is still treated as exempt income if it arises to the non-resident trust.[273] Hence, all amounts that would not have constituted income if received by a South African resident, falls outside the ambit of section 7(8). Only if the amounts would have constituted income in South Africa can the amounts be attributed to the resident donor and taxed in the resident donor's hands. However, there is an important caveat that limits the exemptions afforded to resident donors.

The relevant section reads as follows:

> "(aA) In determining, for purposes of paragraph (a), whether an amount received by or that accrued to a person who is not a resident would have constituted income had that person been a resident, the provisions of section 10B (2) (a) must be disregarded in respect of a receipt or accrual consisting of or derived, directly or indirectly, from a foreign dividend—
>
> (i) paid or payable by a company if—
>
> (aa) more than 50 per cent of the total participation rights, as defined in section 9D (1), or of the voting rights in that company are directly or indirectly held or are exercisable, as the case may be, by that person whether alone or together with any one or more persons that are connected persons in relation to that person; and
>
> (bb) the resident who made the donation, settlement or other disposition or any person that is a connected person in relation to that resident is a connected person in relation to the person who is not a resident; and
>
> (ii) to the extent to which that foreign dividend is not derived from an amount that must be included in the income of or that must be attributed as a capital gain to—
>
> (aa) the resident who made that donation, settlement or other disposition; or
>
> (bb) a resident who is a connected person in relation to the resident referred to in item (aa)".[274]

Section 7(8)(aA) was recently enacted to address the perceived abuse of the participation exemption afforded to residents.[275] This subsection targets an

[272] Clegg & Stretch *Income Tax in South Africa* para 17.3.7.
[273] Para 17.3.7.
[274] Section 7(8) of the ITA.
[275] De Koker & Williams *Silke on South African Income Tax* paras 4, 67B, 12.28 and 12.31.

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arrangement that aims to circumvent the application of section 7(8). The section provides that where a foreign trust receives dividends from a foreign company, in which the trust can exercise more than 50% of the participation or voting rights in said company, either by itself or collectively through any connected person, then, the participation exemption will not be available to the non-resident trust.[276] This provision does not apply to a foreign dividend that is derived from an amount that must be included in the income of or attributed as a capital gain to that resident, or to any person who is a connected person in relation to said resident.[277]

Before section 7(8)(aA) was enacted, it meant that the application of section 7(8) could be avoided by using a non-resident trust and a foreign company in which the non-resident trust held the majority of the shares in the foreign company, the participation exemption would then have applied, which would have meant that the foreign dividends would not have been taxable in the resident's hands, thereby escaping tax in South Africa. If the resident donor was a company, the foreign company would previously not have qualified as a CFC, which means that the foreign company would not have been subjected to the CFC regime.[278] To this extent, the definition of CFC was also amended to make provision for the aforesaid scenario.[279]

If one revisits the example above, let's suppose that the non-resident trust owns 60% of the shares in foreign company X and 20% of the shares in South African company Y, respectively. If company X declares dividends of R150 000 and company Y declares dividends of R70 000, the dividends from company Y will constitute exempt income and cannot be attributed to the resident donor. Similarly, if the participation exemption applied, the foreign dividend amount would not have constituted income if the non-resident was a resident, and hence, the foreign dividends could not have been attributed to the resident donor. However, in this case, the participation exemption will not be available. Thus, the R150 000 foreign dividend income will be regarded as income and will be attributed and taxed accordingly. This is because the participation exemption pertaining to foreign dividends will no longer be applicable since the trust controls more than 50% of the participation or voting rights in company X, which declared the dividends. If the trust only owned 40% of the shares, the exemption would

[276] Paras 4, 67B, 12.28 and 12.31.
[277] Paras 4, 67B, 12.28 and 12.31.
[278] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[279] Section 1 of the ITA: "Definition of controlled foreign company".

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have been available to the resident donor. It should be noted that the determining factor is not whether the trust owns more than 50% of the participation or voting rights in the company, but rather whether the trust can control more than 50% of the participation or voting rights in the company. This means that even if, for example, the trust owns 40% of the shares but connected parties to the trust collectively own more than 10%, then the trust would satisfy the requirement of more than 50% of the participation or voting rights in the company.

It is submitted that the application of section 7(8), must be dealt with on a case-by-case basis. Only on the proper examination of the facts and all circumstances can it be determined whether the income is truly attributable to the donation. The section allows for an apportionment to be made, in the instance that the cause is not clearly ascertainable.[280]

As with the other subsections of section 7, section 7(8) also covers the situation where a resident makes an interest-free loan to the non-resident trust, in an attempt to circumvent donations tax legislation.[281]Hence, the donor is not taxed on an imputed amount of interest but rather an actual amount received by the trust.

Once again, this is best illustrated by use of an example. Suppose a South African resident lends an amount of R1 000 000 interest-free to a non-resident trust. In such a case, it is important to note that only the interest-free part of the loan is deemed to be a disposition for purposes of section 7(8) of the ITA. This means that the income attributed to the donor, is limited to the aggregate interest that should have been charged on the loan amount. Or differently put, the omission to charge interest on the principal amount constitutes a continuing donation on such loan.

In determining the rate of interest that should be charged, one should consider what the trust would have paid had it borrowed the funds on normal commercial terms and not the rate at which the lender could potentially borrow.[282] With this backdrop, continuing with the example, suppose that this notional interest rate is 10%. Even though the rate at which interest is to be calculated is 10%, it does not mean that 10% of the principal loan amount, which equates to R100 000, of interest income is attributable to the resident. Instead, what is required is an analysis of the receipts and accruals of the trust itself. If the trust only earned interest income of R40 000, and

[280] De Koker & Williams *Silke on South African Income Tax* paras 12.28 and 12.31.
[281] Olivier & Honiball *International Tax: A South African Perspective* 572.
[282] Honiball & Olivier *The Taxation of Trusts in South Africa* 92.

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rental income of R35 000 in tax year 1, the resident lender's tax liability will be limited to the taxation of the interest of R40 000 and rental of R35 000. Thus, the resident lender will be subjected to tax on a total amount of R75 000, as if those amounts were received by the lender himself and nothing else. However, if the amount of R75 000 was instead derived from dividend income and not a mixture of interest and rentals, said dividend amount would be disregarded for the calculation. In other words, because the dividend income does not constitute income, the lender will accordingly not be taxed on the dividend amount.

As a logical extension, if the trust had earned no income in the relevant year but rather realised a capital gain of R50 000, then the lender would be liable for CGT on an amount of R50 000 in terms of para 72 of the Eighth Schedule, which applies where a resident donates to a trust and a capital gain attributable to that donation arises.[283] In such a case, the gain must be considered in determining the aggregate capital gain or aggregate capital loss of the resident lender or donor.

The balance of the R100 000 notional interest, which is not "utilised" in the current year of assessment, is carried over to the next year. In this instance, an amount of R75 000 was included in the resident taxpayer's income. Therefore, a balance of R25 000 is carried forward to the next and subsequent years.

This means, in year 2, an amount of R100 000 notional interest plus an amount of R25 000, that was brought forward from the previous year, will be taken into account in the calculation of the income that should be attributed to the resident donor because no interest was charged. This gives a total of R125 000. If the trust earned income of R115 000 in year 2, the amount included in the resident donor's income is not limited to R100 000. Instead, the full R115 000 will be included. The balance of R10 000 will once again be carried over to the next year. Conversely, suppose the trust generated R150 000 in year 2. In that case, only an amount of R125 000 will be included in the donor's income. The balance of R25 000 will escape tax, up until it is distributed to a resident beneficiary. At that stage, the distribution will be taxed in terms of section 25b(2A).[284]

Based on the above, it is clear that the amount attributable to the resident lender is ultimately determined by the income received by or that accrues to the trust in that

[283] Clegg & Stretch *Income Tax in South Africa* para 17.3.7.
[284] Section 25B(2A) of the ITA.

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year of assessment and not fixed to the notional rate. Following this line of reasoning, it means that should the trust not receive any income in a specific year, no income will be attributed to the lender for said year under review. The notional interest portion will then be carried over to the next year where it can be taken into account.

The income will continue to be attributed to the donor until all the amounts that was carried over from the notional interest in the previous years have been included. This means it may be that the trust sells the asset in a specific year, but the subsequent income is still attributed to the donor for a period thereafter. Only once the outstanding income is fully utilised will the attribution stop.[285]

There are however some exceptions. The provision is not applicable in the instance where a donation is made to an institution that is similar in nature to that of a public benefit organisation. The same applies if the non-resident is a CFC.[286] If the non-resident is a CFC, the income derived by the CFC will be imputed to the resident who holds more than 50% of the participation or voting rights in the company by virtue of section 9D of the ITA.

Closely aligned to the above is subsection (b) of the provision. It provides for the deduction of the expenses, allowances or losses that the foreign person, had he been a resident, would have been entitled to.[287] Such expenses are deemed that of the resident in determining his taxable income from that amount, as long as the deductions do not exceed the amount included in the resident's income.

5 2 3 Section 7C

In pursuance of the objective to further clamp down on the use of trusts for tax avoidance, section 7C was introduced to curb the tax-free transfer of wealth from one generation to the next by using interest-free or low-interest loans to trusts.[288] By financing trusts through interest-free or low-interest loans, one was able not just to circumvent donations tax on the transfer but also reduce the value of one's estate,

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[285] De Koker & Williams *Silke on South African Income Tax* paras 12.28 and 12.31.
[286] Clegg & Stretch *Income Tax in South Africa* para 17.3.7.
[287] De Koker & Williams *Silke on South African Income Tax* paras 12.28 and 12.31.
[288] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018" (2018) *Treasury* <http://www.treasury.gov.za/legislation/acts/2018/Explanatory%20Memorundum%20on%20the%202018%20TLAB-17%20January%202019.pdf> (accessed 19-01-2022).

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which in turn resulted in a lower estate duty liability.[289] Due to the fact that the loan is an interest-free loan or a loan with interest below market rates, no interest is paid by the trust to the seller, alternatively, if interest is paid, it is less than at market rates. Therefore, such an arrangement not only affects donations tax and estate duty but also has an adverse income tax implication for the fiscus. According to the National Treasury, such practice diminishes South Africa's fiscal position and erodes the tax base.[290]

Even though this dissertation's scope is limited to the discussion of trusts for income tax purposes, the discussion of section 7C is nevertheless relevant. Although the main aim of section 7C is to prevent the avoidance of donations tax and estate duty, section 7C may have unintended but potentially devastating consequences on South Africa's investor appeal and for the attractiveness of the trust in large. Hence, the discussion of this provision is vital in positioning South Africa as a preferred investment destination and constitutes an important tool in SARS's arsenal of anti-avoidance provisions, specifically aimed at arrangements involving trusts.

The discussion will commence with a brief background of the provision and the motivations for its enactment, followed by an overview of the substantive aspects of section 7C. Although the discussion aims to provide the reader with a thorough understanding of the provision and its greater impact on the South African trust regime, the discussion will not consider all the estate planning consequences in detail.

5 2 3 1 Background

For many years now, trusts have been under attack by governments worldwide.[291] The perception that trusts are mainly used by the wealthy to avoid taxes has resulted in an unprecedented review of legislation and scrutinising the regulatory environment with renewed interest.[292] This negative perception that trusts are the cause of all

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[289] Botha et al *Estate Planning and Fiduciary Services Guide* 130-131.
[290] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2016" (2016) *Treasury*.
[291] T Graham "Trusts in prime jurisdictions" (2011) 17 *Trusts & Trustees* 136-137; RH Sitkoff & MM Schanzenbach "Jurisdictional competition for trust funds: an empirical analysis of perpetuities and taxes" (2005) *Law and Economics Working* Paper 14; B Harrington "Trusts and financialization" (2017) 15 *Socio-Economic Review* 31.
[292] E Casi-Eberhard, Spengel C & Stage B "Cross-border tax evasion after the common reporting standard: game over?" (2018) *Centre for European Economic Research Discussion Paper* 18-036; H Christensen & Tirard J-M "The amazing development of exchange of information in tax matters: from

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problems is further fuelled by global media focusing on extreme examples of tax avoidance or cases of misuse by the rich and famous.[293] The ongoing socio-economic issues faced in South Africa, the increased awareness of arrangements where the trust structure has been abused, coupled with the rising need for revenue and the dwindling tax base, has sparked a drastic shift in the regulatory attitude towards trusts.[294]

Over recent years, the South African government has made it increasingly difficult for trusts to operate. The appeal of trusts has been significantly diminished by the ever-increasing unfavourable tax treatment. Previously trusts were regarded as a flexible structure that could provide solutions to various problems, but lately, many people are questioning the benefits of still using trusts.[295] This has resulted in trusts no longer being the preferred choice for many. Based on recent legislative amendments, it appears that government views trusts as something that facilitates immoral activities and should be discouraged.[296] Instead of adopting a neutral approach, the default view is that all trusts are used for abuse. The perception has been created that trusts that remain in existence is an opportunity to exploit a previously underutilised source of much-needed tax revenue.[297]

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double tax treaties to FATCA and CRS" (2016) 22 *Trustees & Trusts* 890; J Christensen, P Coleman & S Kapoor "Tax avoidance, tax competition and globalisation: making tax justice a focus for global activism" (2004) *Global Tax Workshop* <https://www.semanticscholar.org/paper/Tax-Avoidance-%2C-Tax-Competition-and-Globalisation-%3A-Christensen-Coleman/dce590856ba58fe9e959e3afcec7267ba09a956b> (accessed 06-03-2022); S Fung "The questionable legitimacy of the OECD/G20 BEPS project" (2017) 10 *Economic Law Review 3*; MP Hampton & J Christensen "Offshore pariahs? Small island economies, tax havens, and the re-configuration of global finance" (2002) 30 *World Development* 1657-1673; RT Kudrle & L Eden "Campaign against tax havens: Will it last? Will it work?" (2003) 9 *Stanford Journal of Law Business and Finance* 39; R Palan & A Nesvetailova "Elsewhere, ideally nowhere: shadow banking and offshore finance" (2013) 16 *Tidsskrifet Politik* 27.

[293] Oxfam International "Inequality and poverty: the hidden costs of tax dodging" (undated) *Oxfam International* <https://www.oxfam.org/en/inequality-and-poverty-hidden-costs-tax-dodging> (accessed 22-01-2022); Oxfam International "Public good or private wealth" (undated) *Oxfam* <https://www.oxfam.org/en/research/public-good-or-private-wealth> (accessed 22-01-2022); A Knobel "Trusts: weapons of mass injustice" (25-09-2017) *Tax Justice Network* <https://taxjustice.net/2017/09/25/response-criticism-paper-trusts-weapons-mass-injustice/> (accessed 22-01-2022); A Cobham "Tax evasion, tax avoidance and development finance" (2005) 129 *QEHWPS*; A Alstadsaeter, N Johannsen & G Zucman Who Owns the Wealth in Tax Havens? *Macro Evidence and Implications for Global Inequality NBER Working Paper* 23805.

[294] P van der Spuy *Demystifying Trusts in South Africa* (2017) 238.

[295] 238-239.

[296] 238-239.

[297] E Louw "Trust hangover continues" (2017) 4 *Money Marketing* 5.

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In 2013 the Minister of Finance announced the creation of a Tax Review Committee, which soon became known as the Davis Tax Committee ("DTC").[298] The Committee's objective was to assess South Africa's tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability.[299] In assessing South Africa's tax policy framework, the DTC has identified the disparity that exists between the number of registered trusts and trusts that are actually registered as taxpayers.[300] The level of tax compliance among trusts has been recognised as an area of concern.

In order to address the aforesaid problem and to align South Africa's tax policy with the developmental goals, the DTC made various recommendations. Amongst other proposals, the DTC recommended that trusts should be treated as a separate taxpayer, that the conduit pipe principle should be abolished, that income splitting should be prevented, that section 7(3) should be repealed and that interest-free loans should constitute a deemed donation.[301]

Although many of the DTC's recommendations have not yet been implemented, far-reaching action was taken to limit the use of interest-free or low low-interest trusts.[302] This manifested through the enactment of section 7C.[303]

5 2 3 2 The reason for section 7C

Before the enactment of section 7C, the use of no-interest or low-interest loans was the preferred method of financing the acquisition of an asset in a trust.[304] Such practice

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[298] The Davis Tax Committee <https://www.taxcom.org.za > (accessed 22-01-2022).

[299] National Treasury "Budget Review 2013" (2013) *Treasury* <http://www.treasury.gov.za/documents/national%20budget/2013/review/fullreview.pdf> (accessed 22-01-2022); Ministry: Finance Republic of South Africa "Terms of Reference for the South African Tax Review Committee" (undated) *TaxCom* <https://www.taxcom.org.za/docs/Davis%20Tax%20Committee%20Terms%20of%20Reference.pdf> (accessed 22-01-2022); The Davis Tax Committee "Macro Analysis of the Tax System and Inclusive Growth in South Africa" (21-04-2016) *TaxCom* <https://www.taxcom.org.za/docs/20160421%20DTC%20Macro%20Analysis%20Final%20Report%20-%20Full%20Report.pdf> (accessed 22-01-2022).

[300] The Davis Tax Committee "Second and Final Report on Estate Duty" (28-04-2016) *TaxCom* <https://www.taxcom.org.za/docs/20160428%20DTC%20Final%20Report%20on%20Estate%20Duty%20-%20website.pdf> (accessed 22-01-2022).

[301] The Davis Tax Committee "Second and Final Report on Estate Duty" (28-04-2016) *TaxCom*.

[302] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2016" (2016) *Treasury*.

[303] Section 7C(3) of the ITA.

[304] Botha et al *Estate Planning and Fiduciary Services Guide* 131.

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was commercially commonplace, entirely compliant with the law, and incurred very few adverse fiscal consequences.[305] It is exactly this practice that the legislator addressed with the enactment of section 7C.

The issue at hand is the lawful avoidance of estate duty and donations tax where a person sells assets to a trust and the sale of those assets is financed via an interest-free loan or a loan bearing interest at below the market rate.[306] In such case, donations tax would not be triggered where the asset was sold at market value to a trust on such terms because the transaction would not have constituted gratuitous disposal, which is a prerequisite before donations tax can be applicable to the transfer. Coupled with the aforementioned, in some instances, the seller would reduce the outstanding loan capital by harnessing the provisions of section 56(2)(b), which affords a person an annual tax-free allowance for donations up to R100 000.[307] This means that the outstanding loan amount is reduced annually without incurring any donations tax liability. This is achieved by donating up to R100 000 per year to the trust, which is set off against the loan amount. For married persons, it is possible to reduce the loan amount by up to R200 000 by combining both parties' tax-free allowance and utilising the tax-free nature of inter-spouse donations.[308] Such arrangements will also result in the avoidance of estate duty, through the tax-free reduction of the asset base of the seller.[309] Since the loan to the trust was interest-free or at less than market rates, little to no interest would be paid to the seller. Hence, the seller would not be liable for income tax on the foregone interest. This results in a further reduction in tax revenue and erodes the country's tax base. In addition to the aforementioned, one of the primary benefits of such arrangements was the so-called estate freeze or pegging phenomenon.[310] In other words, by transferring the assets to the trust, the seller cannot only freeze his estate at the current value but can also ensure that the growth in value of the asset takes place in the hands of the trust. Hence, the asset can grow in value without attracting estate duty.

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[305] De Koker & Williams *Silke on South African Income Tax* para 12.38A.
[306] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[307] Van der Spuy *Demystifying Trusts in South Africa* 8.
[308] 12-13.
[309] Davis, Beneke & Jooste *Estate Planning* para 6.12.
[310] N Sekabate "News & Press: decreased Estates and Estate Duty" (15-02-2017) *The SAIT* <https://www.thesait.org.za/news/331070/Introduction-of-section-7C-to-the-Income-Tax-Act-and-its-effect-on-estate-planning-.htm> (accessed 01-02-2022).

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5 2 3 3 The provision

Section 7C targets the situation where a person makes an interest-free or low-interest loan to a trust.[311] In such a case, the operation of the provision deems the foregone interest on the loan as a continual donation.[312] This means that the donor will be liable for donations tax on the difference between the interest rate charged on the loan and the official rate of interest.

Due to the wording used in the provision, the provision applies to a wide range of circumstances. Since the enactment of section 7C, the provision has been amended numerous times.[313] These amendments exacerbated the complexity of the provision, expanded the already wide ambit, and introduced far-reaching anti-avoidance rules.[314]

Throughout section 7C, the phrase "loan, advance or credit" is used to denote the range of transactions contemplated by the provision. However, the phrase is not defined in section 7C, neither is there a definition in the ITA. Thus, one must follow the normal interpretation rules to devise the meaning. In line with the *Natal Joint Municipal Pension Fund* case, one must consider the ordinary meaning of the words in the context, while being cognisant of the purpose of the provision.[315]

According to the Lexico dictionary, the term loan refers to "a thing that is borrowed, especially a sum of money [or principal amount] in exchange for future repayment of the value or principal amount plus interest".[316] Conversely, the Merriam-Webster dictionary defines the word "advance" as "a provision of something (such as money or goods) before a return is received".[317] The concept of credit can be understood as the ability of a person to obtain goods or services before payment, based on the trust that payment will be made on a specified future date, typically with the addition of interest.

Based on the above definitions, it is clear that all three words used in the phrase loan, advance or credit are considered synonyms of one another. Broadly speaking,

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[311] De Koker & Williams *Silke on South African Income Tax* para 12.38A.
[312] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[313] De Koker & Williams *Silke on South African Income Tax* para 12.38A.
[314] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.
[315] *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 4 SA 593 (SCA).
[316] Lexico "Loan" (undated) *Lexico* <https://www.lexico.com/definition/loan> (accessed 2022-02-01).
[317] Merriam-Webster "advance" (undated) *Merriam-Webster* <https://www.merriam-webster.com/dictionary/advance#:~:text=1%20%3A%20to%20move%20forward%20Advance,100%20dollars%20from%20my%20wages> (accessed 01-02-2022).

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these terms refer to an arrangement whereby one person provides a sum of money to another person, with the expectation that the receiving party will repay the sum of money received, subject to certain terms. Although there is a slight variation in the meaning of each term, they apply to different scenarios depending on the case context. Collectively, the phrase ensures that all possible permutations are covered. In addition, the deeming provisions of section 7C further expands the already wide ambit.

In light of the above, it is questionable whether section 7C can apply to a beneficiary that has a vested right in the trust's income, but the income has not been distributed to the beneficiary. Since the income is already vested in the beneficiary, the beneficiary unconditionally owns the income.[318] Therefore, by virtue of section 25B(2), the beneficiary will be subject to income tax on the income and not the trust.[319] This is also the case for any further income that arises as a consequence of the original amount. Such vested right to the income will further form part of the beneficiary's estate.

Trust deeds often state that trustees do not have to pay a distribution immediately but rather that such amount can be retained in the trust, until such time that the trustees exercise their discretion to transfer the amount to the beneficiary.[320] However, if the vested amount is retained in the trust, does such retention constitute a loan for purposes of section 7C? Put differently, the amount is the property of the beneficiary, but the trust is in possession thereof. In such a case, it will depend on the reason for the non-distribution. As well as whether the trustees clearly indicate that said amount is held on behalf of the beneficiary or whether the trustees still treat said amount as trust property.

In the instance that the non-distribution results from an election exercised by the beneficiary, or as a result of a request by the beneficiary, such retention will qualify as an interest-free loan to the trust, which means that section 7C will apply, provided that the trustees accede to the beneficiary's request.

It is submitted that by exercising a choice for the amount to be retained in the

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[318] Van der Merwe (2000) *SA Merc LJ* 319.

[319] Section 25B(2) of the ITA.

[320] T Davey "Section 7C – beneficiary awards and loans" <https://daveyvos.co.za/%EF%BB%BFsection-7c-beneficiary-awards-and-loans/> (accessed 05-02-2022).

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trust, the beneficiary is knowingly a party to the arrangement. This is an important point since by definition a loan cannot be made unilaterally. Hence, it is correct to regard the consensual retention as a loan to the trust. It follows that if no provision is made to levy interest, or if interest is levied at less than the official rate, the beneficiary will be liable to donations tax on the foregone interest on the loan and income tax on any income that arises from the loan amount.

However, if the non-distribution is deferred at the discretion of the trustees and the amount is invested on behalf of the beneficiary, such retention will not constitute a loan and will fall outside the ambit of section 7C. But if the amount is not invested on behalf of the beneficiary but instead invested on behalf of the trust, such retention may give rise to a qualifying loan for the purpose of section 7C.

It is submitted that if the retention is made at the discretion of the trustees, such retention will not constitute a loan. The aforesaid stems from the notion that no loan can come into existence without the consent of the lender. Thus, because there is no loan, advance or credit, section 7C cannot apply. It is further submitted that if the amount is retained at the trustees' discretion, but the records do not properly reflect that the amount is invested on behalf of the beneficiary, such retention cannot give rise to an interest-free loan to the trust. Hence, the improper administration of the trust by the trustees should not result in adverse tax consequences for the beneficiary.

The provision applies retrospectively to all trusts and loan arrangements that either charge no interest or a rate less than the official interest rate.[321] This means that not only newly formed trusts or loan arrangements but even trusts that are already in operation at the date of enactment, and loans previously made to such trusts will be caught by the working of the provision. It is submitted that this retrospective nature of section 7C may have serious implications for existing trusts with long-standing interest-free loan arrangements. Depending on the purpose of such loans, it may be that the sustainability of the arrangement is now in question.

Although it may be argued that such retrospective application is unfair, it should be borne in mind that unfairness *per se* is not a ground on which a legislative provision can be declared unconstitutional unless the legislative provision infringes on a fundamental right or if the provision in question is irrational.[322]

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[321] De Koker & Williams *Silke on South African Income Tax* para 12.38A.

[322] *Pienaar Brothers (Pty) Ltd v Commissioner for the South African Revenue Service* 2017 6 SA 435 (GP).

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Section 7C applies to any such loan arrangement that extends an interest-free or low-interest loan to a trust, regardless of whether such loan was made directly or indirectly by a person or company that is connected to said trust.[323] In addition, the provision will also apply if such loan is made to a company, if the trust or persons connected to said trust collectively own 20% of the issued shares of the company or can exercise 20% of the voting rights in said company.

Based on the wording used in section 7C, it is likely that the provision can apply to both resident persons and non-resident persons alike. Unlike in the case of section 7(8),[324] the provision does not explicitly refer to resident persons, but throughout section 7C, the section rather just refers to natural persons, companies and trusts respectively.[325] The same omission is encountered among others in section 7(5), where no mention of residents is made.[326] In that context, it is considered that section 7(5) can equally apply to both resident and non-resident donors, as well as to resident trusts and non-resident trusts.[327] However, if one considers that section 7C is a derivative of donations tax and not income tax as section 7(5), coupled with the fact that donations tax generally does not apply to non-residents, it is questionable whether section 7C should override this principle. Thus, it is submitted that section 7C should be interpreted restrictively so that the provision only applies to resident lenders. But no valid justification exists to exclude non-resident trusts from the ambit of the provision. If section 7C is construed in such a way, it will result in non-resident trusts being treated more favourably than their resident counterparts.

The relevant section reads as follows:

"(1) This section applies in respect of any loan, advance or credit that—

(a) a natural person; or

(b) at the instance of that person, a company in relation to which that person is a connected person in terms of paragraph (d) (iv) of the definition of connected person, directly or indirectly provides to—

(i) a trust in relation to which—

(aa) that person or company; or

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[323] De Koker & Williams *Silke on South African Income Tax* para 12.38A.
[324] Section 7(8) of the ITA.
[325] Section 7C.
[326] Section 7(5).
[327] Honiball & Olivier *The Taxation of Trusts in South Africa* 88.

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(bb) any person that is a connected person in relation to the person or company referred to in item (aa), is a connected person; or

(ii) a company if at least 20 per cent of—

(aa) the equity shares in that company are held, directly or indirectly; or

(bb) the voting rights in that company can be exercised, by a trust referred to in paragraph (i) whether alone or together with any person who is a beneficiary of that trust or the spouse of a beneficiary of that trust or any person related to that beneficiary or that spouse within the second degree of consanguinity." [328]

Shortly after section 7C was enacted, tax professionals started devising arrangements that will circumvent the operation of the provision. However, SARS promptly responded by introducing retrospective amendments to close these loopholes.[329]

For example, the ambit of the provision was extended to also apply in the circumstances that a person transfers an existing loan to a trust or company to another person, provided that such other person is connected to that trust or to a previous lender.[330] In such case, section 7C will apply to the acquirer of that loan if the provision was applicable to the lender before the transfer occurred. If the acquirer of the loan is not a connected person to that trust or a previous lender, but subsequently becomes a connected person, section 7C will apply from that later date.

The relevant section reads as follows:

"(1A) If a person acquires a claim to an amount owing by a trust or a company in respect of a loan, advance or credit referred to in subsection (1), that person must for purposes of this section be treated as having provided a loan, advance or credit to that trust or company—

(a) on the date on which that person acquired that claim; or

(b) if that person was not a connected person on that date in relation to—

(i) that trust; or

(ii) the person who provided that loan, advance or credit to that trust or company, on the date on which that person became a connected person in relation to that

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[328] Section 7C(1).

[329] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018" (2018) *Treasury*.

[330] Section 7C(1A) of the ITA.

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trust or person, that is equal to the amount of the claim so acquired".[331]

Before the provision was amended in 2017, it was possible to avoid the working of section 7C by making interest-free or low-interest loans to companies whose shares are held by trusts. By advancing the loan to the company rather than the trust, the original anti-avoidance measures from 2016 did not apply to the transaction. At that stage, the scope only extended to loans by a natural person or a company (at the instance of a natural person) to trusts.[332] Therefore, the provision was subsequently amended to also cover the above situation.[333] It is submitted that interest-free loans within a group of family companies, where the shares of said companies are owned by a trust, may now also fall in the ambit of section 7C, despite the fact that these types of loans are often used for legitimate commercial reasons.[334]

However, the above amendment did not adequately foresee nor protect against all possible configurations of such structures. It soon came to government's attention that taxpayers have constructed a variation on the arrangement to circumvent the deemed annual donation triggered by the anti-avoidance measure.[335] In such a case, the operation of the anti-avoidance measure is being avoided by natural persons that subscribe for preference shares with no or a low rate of return in a company owned by a trust that is a connected person to those individuals.[336] Thus, such arrangements that use preference shares as a funding method, were able to avoid the application of the provision's anti-avoidance rules, because the 2017 changes only applied to a company that is owned by a trust that is a connected person in relation to the natural person advancing that loan. In order to curb this

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[331] Section 7C(1A).

[332] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018" (2018) *Treasury*.

[333] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017" (2017) *National Treasury* <http://www.treasury.gov.za/public%20comments/TLAB%20and%20TALAB%202017%20Draft/2017%20Draft%20Explanatory%20Memorandum%20on%20the%202017%20draft%20TLAB%20-%2019%20July%202017.pdf> (accessed 19-02-2022).

[334] KPMG Private Enterprise "Family office & private client" (2021) *KPMG* <https://assets.kpmg/content/dam/kpmg/us/pdf/2021/05/tnf-sa2-may26-2021.pdf> (accessed 19-02-2022).

[335] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018" (2018) *Treasury*.

[336] De Koker & Williams *Silke on South African Income Tax* para 12.38A.

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abuse, section 7C(1B) was inserted.[337] As a result, the subscription price of preference shares will be deemed to be a loan advanced.[338] In addition, any dividends in respect of those preference shares shall, for purposes of section 7C, be deemed to be interest in respect of such a deemed loan.[339]

The relevant section reads as follows:

> "(1B) Where—
>
> (a) a natural person; or
>
> (b) at the instance of a natural person, a company that is a connected person in relation to that natural person in terms of paragraph (d) (iv) of the definition of "connected person", subscribes for a preference share in a company in which 20 per cent or more of the equity shares are held (whether directly or indirectly) or the voting rights can be exercised by a trust that is a connected person in relation to that natural person or to that company, whether alone or together with any person who is a beneficiary of that trust—
>
> (i) consideration received by or accrued to that company for the issue of that preference share shall be deemed to be a loan for the purposes of subsection (3); and
>
> (ii) any dividend or foreign dividend accrued in respect of that preference share shall be deemed to be interest in respect of the loan contemplated in paragraph (i)."[340]

In respect of a transaction that falls within the ambit of section 7C, the provision further limits possible avoidance of the deemed annual donation by prohibiting the lender from claiming any deduction or loss in respect of the interest charged on the loan. The provision covers all scenarios whereby any amount owing under the loan is reduced or waved, or where there is an omission to claim payment.[341] This means that section 7C(2) creates a legal fiction that deems the lender to have received the interest due under the loan, even though the trust was unable to pay, and in fact, did not pay said interest. The result of the aforesaid, is that a taxpayer that extends an interest-free or

[337] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018" (2018) *Treasury*.

[338] Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.

[339] De Koker & Williams *Silke on South African Income Tax* para 12.38A.

[340] Section 7C(1B).

[341] Section 7C(2).

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low-interest loan to a trust will potentially be liable for tax on interest that was never received and where no realistic prospect exists of receiving payment at a future date.

The relevant section reads as follows:

> "(2) No deduction, loss, allowance or capital loss may be claimed in respect of
>
> (a) a disposal, including by way of a reduction or waiver; or
>
> (b) the failure, wholly or partly, of a claim for the payment, of any amount owing in respect of a loan, advance or credit referred to in subsection (1)."[342]

The core of the provision is contained in section 7C (3), which provides that if a trust enters an interest-free or low-interest loan, advance or credit arrangement that falls within the ambit of section 7C (1) or any of the other subsections, the foregone interest on the loan will constitute an ongoing donation from the lender to the trust.[343] The value of such a deemed donation is equal to the difference between the amount of interest incurred by the trust and the amount that would have been incurred by the trust if interest was levied on the loan at the official rate of interest.[344] For purposes of the provision, the deemed donation is considered to have been made on the last day of the trust's tax year.[345] But, various practical difficulties remain unresolved.[346] Furthermore, the amount of the donation is calculated in each year of assessment for so long as the loan remains in existence.[347] However, individual taxpayers can still utilise their annual donations tax exemption to offset the deemed donation liability arising from the interest-free or low-interest loan to the trust.[348]

This can be illustrated by way of an example. Suppose that person A establishes a discretionary trust X for the benefit of his children B and C. In this example, both B and C are over the age of majority. As a way of providing finance to the trust, person A lends R5 million to trust X. The capital is used to purchase income-producing immovable property. The loan was made interest-free to the trust, and there is no fixed

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342 Section 7C(2).
343 Section 7C(3).
344 Section 7C(3).
345 Section 7C(3).
346 I Lamprecht "Concern about practical challenges with new trust legislation" (undated) *MoneyWeb* <https://www.moneyweb.co.za/in-depth/fisa/concern-about-practical-challenges-with-new-trust-legislation/> (accessed 12-02-2022).
347 De Koker and Williams *Silke on South African Income Tax* para 12.38A.
348 Davis *et al Juta's Commentary on Income Tax*, Commentary on s 7.

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repayment date.

Before the enactment of section 7C, the scenario described above was a popular way of mitigating a person's estate duty liability.[349] Such an arrangement was further completely in compliance with the law and was regarded as an acceptable strategy.[350] By adopting the aforesaid structure, person A was able to utilise the annual donations tax exemption to reduce the outstanding loan amount by donating R100 000 to trust X each year until the loan has been paid in full. In this way, person A has successfully transferred wealth to trust X, without incurring any adverse tax liability. Not only was person A able to avoid donations tax on the transfer, but also managed to reduce the value of his estate. This was achieved by shifting R5 million to trust X, and by purchasing the immovable property in trust X, those growth assets will increase in value, but the capital growth occurs in trust X's hands, and not in the estate of person A.

However, with the introduction of section 7C, the above scenario has changed significantly. If one applies section 7C to our example, it is clear that the interest-free loan by the founder to the trust, will definitely trigger the provision. This means that person A will be liable for donations tax on the difference between the interest actually charged on the loan, and the official rate of interest. In our example, the loan incurs no interest. The official rate of interest is calculated as the repo rate plus one per cent.[351] Assume that the official interest rate is set at 4,5%. In other words, according to the provision, person A should have charged 4,5% on the loan to trust X. This translates to R225 000 interest per annum on the loan amount. Hence, person A will be liable to 20% donations tax on the deemed donation of R225 000 per year. Nevertheless, it is still possible for person A to offset this deemed donation amount against the donations tax allowance. Should person A decide to utilise the person A will only be liable for donations tax on the remaining R125 000, which results in a liability of R25 000 per annum. This liability will persist until trust X has repaid the loan to person A, or such time that the loan terms are amended to make provision for interest, at a rate that is at least equal to the official rate. Alternatively, person A can reclassify the loan as an outright donation to trust X and settle the resulting donations

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[349] Lamprecht "Concern about practical challenges with new trust legislation" (undated) *MoneyWeb*.
[350] De Koker & Williams *Silke on South African Income Tax* para 12.38A.
[351] Obviously, the repo rate fluctuates over time, but for purposes of the dissertation a repo rate of 3,5% will be used.

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tax liability once off. Because the R5 million transfer to trust X is now a donation, the donation will incur donations tax on the total amount donated to trust X. If person A elects this option, person A will be liable for a once-off donations tax liability of R1 million. Naturally, it is also possible to utilise the annual tax-free allowance in the year of assessment that the donation of R5 million is made, which will reduce the donated amount to R4,9 million. Person A's final donations tax liability will thus be R980 000.

The operation of the provision hinges on the notion that a loan to a trust is at more favourable terms than what could be achieved on the open market.[352] The benchmark used for this determination is the official rate of interest. By enacting the provision, the legislator, in effect, determined that the minimum interest rate on a trust loan is set at the official interest rate. This means that an interest-free or low-interest loan arrangement that would otherwise trigger the operation of section 7C, can lawfully be avoided by amending the terms of the agreement so that interest is charged on the loan to the trust at the official rate of interest. In such a case, the minimum interest threshold would be achieved, and therefore, the provision will no longer be applicable.

If the above example is amended to charge interest at the minimum rate of 4,5%, it would mean that the interest received on the loan will cause person A's estate to grow. In monetary terms, the trust will be liable to pay person A interest of R225 000 per year on the R5 million loan. However, in this case, it is not possible to reduce the interest as was the case if the provision applied to the interest-free loan. Hence, the best option for person A would be to make an interest-free loan and offset the deemed donation on the foregone interest by utilising his annual tax-free donation allowance. It is submitted that despite the application of section 7C, in a low interest rate environment, the use of interest-free loans to finance trusts are still the most tax-efficient method.

Even though the provision has a very wide ambit, the provision uses the connected person requirement to limit the circumstances to which the core rule applies. Section 7C(3)'s scope is reduced in two ways: Firstly, the rule applies only where the company at whose instance the natural person has provided the loan, advance or credit is a company in relation to which that a natural person is a connected person in terms of paragraph (d)(iv) of the ITA.[353] In effect, this means any natural

[352] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2016" (2016) *Treasury*.
[353] De Koker & Williams *Silke on South African Income Tax* para 12.38A.

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person who, individually or jointly with any connected person, holds at least 20 per cent of the equity shares or voting rights in the company. Second, the rule applies only to the extent that the recipient trust is one in respect of which that natural person or that company, or any person who is a connected person in relation to that natural person or company, is a connected person.[354]

The scope of the core rule extends to cover the situation where a company provides an interest-free or low-interest loan to a trust if said loan was made at the instance of a natural person or at the instance of a company in relation to which that person is a connected person.[355] Unfortunately, the ITA provides no definition for the phrase "at the instance of". However, interpreting the aforesaid, it can be derived that it means a loan that was made at the request or at the instruction of the natural person. In other words, it means that the loan would not have been extended to the trust on such terms if it was not for that natural person's influence on the lender.

The application of section 7C does not take into account the motivation for structuring the transaction in a specific way. This means that the provision is not limited to a situation where the loan is made to transfer wealth without incurring any tax liability. The fact that it made good commercial sense, in all the circumstances, for the loan to the trust to be interest-free or at low interest (such as the trust's financial incapacity to pay interest) is irrelevant. It is submitted that the ambit of section 7C extends much further than necessary to achieve the stated purpose, which is to prevent the avoidance of estate duty. To this extent, it is submitted that a motive or purpose test should be introduced, which will ensure that all commercial arrangements are excluded from the provision.

The relevant section reads as follows:

"(3) If a trust or company incurs—

(a) no interest in respect of a loan, advance or credit referred to in subsection (1), (1A) or (1B); or

(b) interest at a rate lower than the official rate of interest, an amount equal to the difference between the amount incurred by that trust or company during a year of assessment as interest in respect of that loan, advance or credit and the amount that would have been incurred by that trust or company at the official

[354] Para 12.38A.
[355] Davis, Beneke & Jooste *Estate Planning* para 6.4.

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> rate of interest must, for purposes of Part V of Chapter II, be treated as a donation made to that trust by the person referred to in subsection (1) (a), (1A) or (1B) on the last day of that year of assessment of that trust".[356]

The provision further provides that where such a loan, advance or credit was provided by a company to a trust at the instance of more than one connected person, the amount of the donation must be divided between such persons on a defined basis. This means that the deemed donation liability must be apportioned among all the connected persons that played a part in influencing the company to make the loan to the trust. Such a person's liability will be calculated in the ratio of their shares or voting rights held in said company.

The relevant section reads as follows:

> "(4) If a loan, advance or credit was provided by a company to a trust or another company at the instance of more than one person that is a connected person in relation to that company as referred to in paragraph (b) of subsection (1), each of those persons must be treated as having donated, to that trust or company, the part of that amount that bears to that amount the same ratio as the equity shares or voting rights in that company that were held by that person during that year of assessment bears to the equity shares or voting rights in that company held in aggregate by those persons during that year of assessment."[357]

Under specific circumstances, section 7C will not apply, even if all the requirements have been met. Section 7C(5) outlines those scenarios that are exempt from the provision.[358] Based on the exempt circumstances, it can be inferred that these scenarios constitute so-called acceptable uses for trusts. By extension, it is fair to say the government tries to encourage the aforesaid uses while discouraging applications which are perceived to facilitate unwanted conduct. It is submitted that these so-called exceptions are yet another attempt to limit the inherent flexibility of trusts. To this extent, the adverse tax consequences of the application of section 7C is used in a punitive way to discourage certain uses of trusts. It is further submitted that the notion that the motive of the loan is irrelevant for purposes of section 7C is contradictory to

[356] Section 7C(3).
[357] Section 7C(4).
[358] Section 7C(5).

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having so-called exempt circumstances. Instead, the motive is only relevant if the motivation for the loan is in line with one of the defined acceptable uses.

The relevant section reads as follows:

"(5) Subsections (2) and (3) do not apply in respect of any amount owing by a trust or company during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) if—

(a) that trust or company is a public benefit organisation approved by the Commissioner in terms of section 30 (3) or a small business funding entity approved by the Commissioner in terms of section 30C;

(b) that loan, advance or credit was provided to that trust by a person by reason of or in return for a vested interest held by that person in the receipts and accruals and assets of that trust and—

(i) the beneficiaries of that trust hold, in aggregate, a vested interest in all the receipts and accruals and assets of that trust;

(ii) no beneficiary of that trust can, in terms of the trust deed governing that trust, hold or acquire an interest in that trust other than a vested interest in the receipts and accruals and assets of that trust;

(iii) the vested interest of each beneficiary of that trust is determined solely with reference and in proportion to the assets, services or funding contributed by that beneficiary to that trust; and

(iv) none of the vested interests held by the beneficiaries of that trust is subject to a discretionary power conferred on any person in terms of which that interest can be varied or revoked;

(c) that trust is a special trust as defined in paragraph (a) of the definition of a special trust;

(d) that trust or company used that loan, advance or credit wholly or partly for purposes of funding the acquisition of an asset and—

(i) the person referred to in subsection (1) (a) or the spouse of that person used that asset as a primary residence as contemplated in paragraph (b) of the definition of "primary residence" in paragraph 44 of the Eighth Schedule throughout the period during that year of assessment during which that trust or company held that asset; and

(ii) the amount owed relates to the part of that loan, advance or credit that funded the acquisition of that asset;

(e) that loan, advance or credit constitutes an affected transaction as defined in

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section 31 (1) that is subject to the provisions of that section

(f) that loan, advance or credit was provided to that trust or company in terms of an arrangement that would have qualified as a sharia compliant financing arrangement as contemplated in section 24JA, had that trust or company been a bank as defined in that section;

(g) that loan, advance or credit is subject to the provisions of section 64E (4); or

(h) that trust was created solely for purposes of giving effect to an employee share incentive scheme in terms of which—

(i) that loan, advance or credit was provided—

(aa) by a company to that trust; or

(bb) for purposes of funding the acquisition, by that trust, of shares in that company or in any other company forming part of the same group of companies as that company (hereinafter referred to as a "scheme company");

(ii) equity instruments, as defined in section 8C, that relate to or derive their value from shares in a scheme company may be offered by that trust to a person solely by virtue of that person—

(aa) being in employment on a full-time basis with; or

(bb) holding the office of director of, a scheme company; and

(iii) a person that is a connected person in terms of paragraph (d)(iv) of the definition of connected person in relation to any scheme company is not entitled to participate in that scheme".[359]

Notwithstanding the above exemptions, no mention is made of what the position is if one of the other provisions of section 7 applies to the circumstances. This raises the question of whether section 7C can apply in addition to that of the subsection of section 7? Or is it rather a case of a specific provision superseding that of a more general provision? If this is the case, it would mean that the other more specific subsections of section 7 will take preference over that of section 7C. In *Isaacs v CIR,*[360] the court held that if one considers the fact that an income tax is fundamentally a tax upon a person's annual profits or gains, the ITA should not be construed as imposing tax upon a taxpayer twice for the same profits unless the language of the statute makes it clear that this result was intended.

[359] Section 7C(3).

[360] 1949 4 SA 561 (A)

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Based on the above principle, it follows that only one provision that results in a person being subject to income tax could apply in any given case. Furthermore, the taxpayer should be entitled to elect which provision he would like SARS to use to subject him to tax.[361] Support for this notion can possibly be found in the *contra fiscum* rule of interpretation.

In *Shell's Annandale Farm (Pty) Ltd v Commissioner for South African Revenue Service*,[362] the court stated that the *contra fiscum* rule could be invoked where a statutory provision is ambiguous as to the intention of the legislature and if such ambiguity is reasonably "implied from the wording of the legislation and such legislation implies a burden upon the subject then that interpretation must be adopted which is in favor of the taxpayer".

However, the above principle is only applicable if both provisions result in an amount being included in a person's taxable income and being subject to income tax, but that is not what the current case entails. Instead, in this case, two different taxes are involved, namely income tax in terms of the provisions of section 7 and donations tax on the foregone interest under section 7C. Hence, in this context, the aforesaid principle cannot be invoked.

Aside from the aforementioned, it is peculiar that an exemption was included for those instances where section 31 or section 64E(4) already applies to the interest-free arrangement, but no exemption is provided if the other subsections of section 7 apply in the circumstances. This means that there is no threat of double taxation if the interest-free loan arrangement is subject to the operation of section 31 or section 64E(4). However, this is not the case with the provisions in section 7.

In light of the above, it is clear that the way in which the provision is currently drafted, there is no reason why section 7C cannot apply concurrently with other subsections of section 7 to the same circumstances.[363] Similarly, section 7C can also apply to non-resident trusts. However, it is debatable whether this was intended, or if the omission of section 7 was merely an oversight on the part of the legislator.

The effect of the aforementioned, is that a person will be subject to donations tax on the foregone interest on the loan to the trust and subject to income tax on the

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[361] Clegg & Stretch *Income Tax in South Africa* para 17.3.6.
[362] [2000] 62 SATC 97.
[363] T Davey "Soft loans to non-resident trusts revisited" (02-07-2022) *Davey Vos* <https://daveyvos.co.za/2019/07/> (accessed 22-02-2022).

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income that arises from the trust utilising the loan. The specific circumstances will determine which provision of section 7 is applicable, provided that all the other requirements of the specific subsection are complied with. However, if the loan does not give rise to any income, none of the subsections of section 7 can apply.

This can best be illustrated by way of an example. If one continues with the example above, let's suppose that beneficiaries B and C are still minors. In this case, the R5 million interest-free loan to trust X is subsequently invested in an interest-bearing account that generates R500 000 interest per annum for the trust. In terms of the trust deed, the trustees have a discretion to apply the funds for the benefit of B and C. The balance of the funds must be paid to B and C when they reach the age of majority.

In this example, section 7(3) will be applicable. This means that person A will be subject to income tax on the interest that should have been charged on the loan to trust X. In the context of section 7, the amount of interest is that which is regarded as normal under the specific circumstances of the case. In other words, the rate that the person would have been charged if it was a bona fide arm's length arrangement. Thus, a market-related rate. But, for purposes of this example, the official rate will be used. This means that R225 000 interest should have been charged on the loan. Thus, person A will be liable to income tax on R225 000. In addition, the interest-free loan will also attract donations tax on the foregone interest in terms of section 7C. Hence, an amount of R225 000 would be deemed to have been donated to the trust, which will result in a donations tax liability of R45 000. However, as illustrated before, by utilising person A's annual tax-free donation allowance, the donations tax liability can be reduced to R25 000 per year.

Although the example illustrates the application of section 7C in the context of section 7(3), section 7C can also apply alongside any of the other provisions in section 7.

To illustrate, let's suppose both B and C are no longer minors. The R5 million interest-free loan to trust X is invested in an interest-bearing account. The investment account attracts interest of 10% per annum, which means that the trust receives R500 000 interest per year. In this case, the trust deed provides that the income must be accumulated in the trust until B and C graduate from university. This means that person A has made the receipt of the income conditional on the obtainment of a specified event. Hence, section 7(5) will apply in these circumstances.

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In this case, by virtue of section 7(5), the R225 000 interest that should have been charged on the loan to trust X will be deemed to be that of person A, which means that person A will be liable to income tax on the foregone interest to the trust. Furthermore, the interest-free loan to trust X will also trigger the operation of section 7C, which will result in person A being subjected to donations tax on the foregone interest on the loan. Thus, the ITA imposes a double sanction on these loans.

As is evident from the examples, the ITA already contained a sanction for the granting of an interest-free or low-interest loan to a trust when the resulting investment income was not distributed to a beneficiary.[364] In other words, the combination of donations tax and section 7 has the same result for true donations, as does the combination of section 7C and section 7 for an interest-free or low-interest loan that is extended to a trust.

This means that the motivation for the introduction of section 7C, insofar as it relates to the avoidance of tax on income, was therefore misplaced. Moreover, the provisions of section 7C result in a double penalty for a single interest-free loan arrangement. However, although the ITA effectively punishes a taxpayer twice in these circumstances, the levying of both donations tax and income tax to the same set of facts does not technically constitute double taxation.[365] Regardless of the technical definition, the practical effect on taxpayers will be the same as double taxation.

Notwithstanding the former, it should be recognised that the granting of an interest-free or low-interest loan to a trust also avoids the liability to donations tax. However, whether one can regard such an arrangement as sufficiently nefarious to justify sanction is debatable. Despite one’s position, it is perfectly legitimate for the fiscus to decide that it now is reprehensible and should be addressed.

It is submitted that the above justification is not convincing, especially if one considers the fact that SARS has overlooked such practice for years. Coupled with the notion that the potential revenue is rather small. However, considering the perception towards trusts and South Africa’s fiscal position, it is probably not implausible.

In conclusion, it is submitted that the initial reaction to section 7C was probably exaggerated and somewhat misplaced. Despite the numerous amendments, there are still uncertainties revolving around the application of the provision. Hence, it is

[364] Clegg & Stretch *Income Tax in South Africa* para 18.14.
[365] Para 18.14.

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submitted that a legislative amendment is required to clarify the meaning of the terms used, the demarcation of the ambit of the provision and to address the other outstanding aspects.

Although the retrospective operation of section 7C is problematic and may have devastating consequences for some trusts with long-standing interest-free loan arrangements, the effect on the majority of trusts will most likely be mild. It is submitted that in the context of a low interest rate environment the tax liability that follows from the application of section 7C, is still significantly less than outright donations tax or even estate duty. However, should the interest rates normalise, the picture may well differ substantially.

5 2 3 4 The in duplum rule

Originally the *in duplum* rule was derived from common law, but in recent years a statutory version of the *in duplum* rule was introduced through the enactment of the National Credit Act ("NCA"). The objective of the *in duplum* rule is to protect borrowers from exploitation by lenders that allow interest to accumulate unabated, leading borrowers into further indebtedness.

In terms of the common-law *in duplum* rule, interest charged on a debt ceases to accrue if the accumulated unpaid interest reaches the point that such amount equals the unpaid principal debt.[366] The statutory *in duplum* rule has a much wider ambit than the common-law *in duplum* rule. To this extent, the statutory *in duplum* rule applies to both unpaid interest and other finance-related costs, whereas the common-law *in duplum* rule is limited to only unpaid interest.[367] As a result, the statutory *"in duplum"* rule is regarded as being more onerous on credit providers and provides greater protection for borrowers.

If a debt constitutes a credit agreement, which is governed by the NCA, the statutory *in duplum* rule overrides the common-law *in duplum* rule.[368] However, if a debt is not regarded as a credit agreement in terms of the NCA, the statutory *in duplum* rule has no application. Hence, in such cases, the common-law *in duplum* rule will apply.

[366] Para 27.28.1.
[367] Para 27.28.1.
[368] Para 27.28.2.

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Soon after the enactment of section 7C, It came to light that some taxpayers are invoking the *in duplum* rule to soften the effect of the provision.[369] Taxpayers are using the *in duplum* rules to distort the quantification of the tax benefit derived from an interest-free or low-interest loan between connected parties on the difference between the amount of interest actually incurred and the amount of interest that would have been incurred at the official rate.[370] These taxpayers contend that if an interest-free or low-interest loan is advanced and the unpaid interest and associated costs on that loan, reaches an amount equal to the unpaid principal debt, the application of the *in duplum rule* stops the interest from accumulating any further.[371] Consequently, if the *in duplum* rule applies, then the operation of section 7C must also be halted. However, with the enactment of section 7D it is clear that taxpayers are not able to rely on the common-law or statutory *in duplum* rule to limit the aggregate amount of interest that can accrue on an interest-free or low-interest loan to a trust.

It is submitted that the enactment of section 7D is a codification of the position adopted in the case of *SARS v Woulidge,*[372] where the court ruled that the *in duplum* rule does not apply to the foregoing interest. Hence, the taxpayer cannot use the operation of the rule to limit his tax liability. Even though the *Woulidge* case revolved around the application of section 7(3), it is submitted that the rationale will equally apply to section 7C. Thus, it is further submitted that section 7D is slightly superfluous. However, the clarification and legal certainty provided by the enactment of the provision are welcomed.

The relevant section reads as follows:

> "Where it must be determined, for the purposes of this Act, what amount would have accrued or been incurred as interest in respect of any loan, debt, advance or amount of credit provided to a person or an amount owed by a person had that interest accrued or been incurred at a specific rate of interest, that amount must be determined—
>
> (a) without regard to any rule of the common law or provision of any Act in terms of which—
>
> (i) the amount of any interest, fee or similar finance charge that accrues or is

[369] Para 27.28.2.
[370] De Koker & Williams *Silke on South African Income Tax* para 12.38A.
[371] National Treasury "Explanatory Memorandum on the Taxation Laws Amendment Bill, 2018" (2018) *Treasury*.
[372] *South African Revenue Service v Woulidge* [2002] 2 All SA 199 (A).

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incurred in respect of a debt may not in aggregate exceed the amount of that debt; or

(ii) no interest may accrue or be incurred in respect of a debt once the amount that has accrued or been incurred as interest is equal to the amount of that debt; and

(b) as simple interest calculated daily."[373]

5 2 4 Conclusion

At the core of the tax treatment of trusts is the notion that South Africa subscribes to the policy position that income received by a trust must only be subject to tax once throughout the trust relationship. Thus, for the taxation of trusts, South Africa primarily applies an initial choice system, and also views the trust structure as a hybrid flow-through entity. However, depending on the circumstances, income received by or that accrues to a trust is either taxed in the hands of the trust, the founder or the beneficiaries. But, regardless of the circumstances, the same income is never taxed more than once.

Like all other taxpayers, trusts that are resident in South Africa are taxed, generally speaking, on their worldwide receipts and accruals, while trusts that are non-residents are typically taxed only on income from South African sources.

In pursuance to section 25B, income received by or that accrues to the trust is either taxed in the hands of the beneficiary or alternatively taxed at the trust level. However, if a SAAR applies, the taxation is no longer governed by section 25B, but rather by the applicable SAAR. The objective of a SAAR is to prevent specific tax avoidance arrangements, which would otherwise result in circumvention or undue reduction in a taxpayer's income tax liability. In the majority of cases, the application of a SAAR results in the income received by or that accrues to the trust to be deemed to be that of the founder and taxed accordingly. Some SAARs attribute the income to the beneficiary. However, it is also possible that the taxable party is outside the trust relationship. In other words, not the trust, beneficiary, or founder.

Based on the preceding discussion, South Africa has an extensive range of SAARs that specifically focuses on the use of trusts. Each provision is enacted to prevent a specific form of abuse and to ensure that no income escapes the income

[373] Section 7D of the ITA.

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tax net. Collectively, these anti-avoidance provisions cover a wide range of scenarios and permutations. However, before any of the anti-avoidance provisions can apply, all the requirements of the specific provision must be complied with.

Non-resident trusts are often used to minimise taxpayers' tax liability in South Africa. However, various SAARs have been introduced to combat this phenomenon. By virtue of section 25B(2A), the accumulated income of a non-resident trust is subject to income tax in South Africa if said income is distributed to a South African resident beneficiary. This means that the South African income tax liability cannot be avoided by accumulating foreign source income in a non-resident trust, which is later distributed as a capital sum.

In addition, section 7 targets various circumstances where income-generating assets are transferred to a trust without due consideration received. Section 7 and its associated subsections target different permutations of so-called income-splitting arrangements. By the operation of section 7, the income that arises, in consequence, of the donation is deemed to be that of the donor and taxed accordingly. In this case, the donor can be the founder of the trust, but it can also be someone else. Section 7(2) is aimed at donations between spouses, while section 7(3) covers donations from parents to their minor children. Conversely, section 7(4) prevents the circumvention of section 7(3) by having someone other than the parent of the child making the donation for said child, in exchange for a reciprocal donation by the parent of the child to the donating party. Section 7(5) targets arrangements whereby a donation is made, but the receipt of the income is subject to the occurrence of a specified event, while section 7(6) addresses the situation where a donation is made, but where a right of revocation is reserved for the donor. Finally, section 7(8) is aimed at donations to non-resident trusts.

In recent years, the use of interest-free or low-interest loans to trusts was identified as problematic. The legislator subsequently responded by enacting section 7C. By virtue of section 7C, the forgone interest on the loan to the trust is deemed to be an ongoing donation and subject to donations tax.

Although it is possible that more than one SAAR may apply to a specific case, income can only be taxed once. Hence, if the income has already been taxed in accordance with one SAAR, the same income cannot be taxed by another provision. However, this rule does not apply to different forms of taxation. In other words, if one SAAR imposes a liability to income tax, it is possible for another SAAR to levy

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donations tax. Thus, in such a case, it is plausible that two SAARs can apply to the same circumstances.

Depending on the specific SAAR, the application can be once off, or the effect can be ongoing. Furthermore, the extent of the operation is determined by the specific facts and circumstances of the case.

Generally speaking, the operation of a SAAR will only cease at the death of the donor or if the trigger is removed. However, what constitutes the trigger for the provision will depend on the applicable SAAR. In some cases, the trigger event may be the donation by the donor, but in others, it may be the conditions imposed or even the rights reserved. It can also be that the SAAR is as a result of the type of the arrangement, the terms of the agreement or an act by the trustees.

If SARS invokes a SAAR for the year of assessment, the taxpayer bears the onus to prove that the SAAR is not applicable. But, if more than one SAAR is potentially applicable, the taxpayer should have the choice in terms of which provision he is taxed. To this extent, the taxpayer will have to furnish SARS with all facts and circumstances of the case. However, the taxpayer is also under the obligation to report a number of qualifying arrangements that may trigger the application of a SAAR.

While it is clear that South Africa has well-developed SAARs that focus on arrangements concerning trusts, the regime is by no means perfect. Instead, various problems regarding the interpretation of key terms and the exact demarcation of the ambits remain unresolved. However, overall, the SAARs largely succeed in their objective, but questions have been raised about whether some of the provisions reach too far.

5 3 United Kingdom

This section follows from the discussion in chapter 4, where the general treatment of trusts for income tax purposes was discussed. With those rules and principles as background, the discussion will now turn to the SAARs applicable to trusts.

Due to the multifaceted nature of the UK's tax system, it may be helpful to divide the proceeding discussion into the following sub-systems, which all relate to the taxation of trusts:

1. settlor-interested trusts (see paragraph 5 3 1 below);
2. transfer of assets (see paragraph 5 3 2 below); and

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3. protected trusts (see paragraph 5 3 3 below).

Each of the above sub-systems can be described as an anti-avoidance regime that operates within the larger income tax system. These sub-systems focus on one specific problem but are closely related. If one adopts a birds-eye approach, it is quite clear that the various aspects form part of a greater picture with one collective aim. Namely, to prevent different permutations of tax avoidance. These so-called regimes are comprised of various provisions that govern the respective regime's criteria, application and consequences.

Similarly, there is also a range of sub-regimes within the other areas of the tax system, which pertain to other taxes such as inheritance tax and CGT. However, as previously indicated, the anti-avoidance provisions under discussion are limited to those that deal with income tax. Hence, those provisions that are specifically focused on inheritance tax fall outside the scope of this dissertation. This is also the case for the provisions pertaining to CGT.

Although those anti-avoidance regimes that primarily focus on inheritance tax do not fall within the ambit of this dissertation, a high-level overview of these regimes will be provided to establish a holistic view of the UK's anti-avoidance provisions applicable to trusts.

To this extent, it is worthwhile to mention some of the most relevant provisions. Depending on the facts of the specific case, it is possible that the following anti-avoidance rules may also be applicable:

1. pre-owned assets; or
2. reservation of benefits.[374]

Considering the close relationship between the uses of trusts and estate planning efforts, it is highly likely that the inheritance tax provisions may apply to a lesser or greater extent. Thus, for purposes of this dissertation, it is sufficient to provide a general overview of what the anti-avoidance provisions try to achieve.

These anti-avoidance rules are aimed at preventing a person from reducing the value of his estate by transferring assets to another person while still enjoying the

[374] J Kessler *Taxation of Non-Residents and Foreign Domiciliaries* 18 ed (2020) para 36.2.

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benefit of the property.[375] In such a case, the transfer is typically without due consideration. The objective of such arrangements is to minimise the taxpayer's inheritance tax liability, without distancing himself from the assets in question.[376]

If one of the above-mentioned provisions applies to an arrangement, by virtue of the provision, under certain circumstances, it may give rise to an additional income tax charge.

Although it is called an income tax charge, it has actually nothing to do with income.[377] In other words, the provisions impose an income tax charge on income which does not exist. It is more accurate to describe the charge as an annual punitive inheritance tax on the value of the property.[378] It is considered that the charge is designed to punish those taxpayers that minimised their tax liability and to force such taxpayers to unwind their estate planning structures, thereby forcing assets that would not have been subject to inheritance tax back into the tax net.[379]

With the aforesaid detour as background, one can now return to the anti-avoidance regimes that form the subject of this dissertation, the discussion will commence with the settlor-interested trust regime.

5 3 1 Settlor-interested trusts

Under certain circumstances, income received by or that accrues to a UK trust will be deemed that of the settlor even though the settlor did not actually receive said income.[380] If a trust is regarded as being settlor interested, or if one of the anti-avoidance provisions applies to the trust, the income will be attributed back to the settlor as if the income was received by said settlor.[381] These provisions can be described as the settlor charging provisions. In such a case, the settlor will be liable for the income tax payable on the income.

The anti-avoidance provisions are aimed at preventing settlors from circumventing their tax liability by arranging their affairs in such a way that their income

[375] E Chamberlain & C Whitehouse *Trust Taxation* 4 ed (2014) 108.
[376] I Maston *Tolley's UK Taxation of Trusts 2018-19* 28 ed (2019) para 4.38.
[377] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.2.
[378] Maston *Tolley's UK Taxation of Trusts 2018-19* para 4.38.
[379] Chamberlain & Whitehouse *Trust Taxation* 110.
[380] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.9.
[381] J Booth *Booth and Schwarz: Residence, Domicile and UK Taxation* (2018) 20 ed 12.

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is received by someone who is either chargeable to tax at a lower rate than the settlor or not chargeable to tax at all.[382]

The settlor will be taxed on the income, capital sums or benefits derived if any one of the following scenarios apply:[383]

1. The settlor retains an interest in the income.
2. The income is paid to or used for the benefit of the settlor's minor children.
3. The settlor receives a capital sum from the settlement or from a body connected to the settlement.

In such a case the income will be taxed in the hands of the settlor as if it arose directly to the settlor. In other words, the income will be taxed in accordance with the income tax provisions that would have applied if the income was received directly by the settlor and not deemed to be the settlor's income.[384] In addition, the same deductions and relief are available to the settlor as would have been the case if the settlor received the income directly.[385] If the income in question arises from either scenario 1 or scenario 2 above, that specific income will be regarded as the highest part of the settlor's total income for tax purposes.[386] However, in both the aforesaid scenarios, the settlor has a right of recovery for the tax paid against the trustees of the settlement or any other person to whom the income is payable.[387] In most cases, it will be the trustees or the beneficiaries that will bear the liability for repayment. Notwithstanding the aforementioned, the settlor will remain liable for the tax charged on the income unless one of the limited exceptions applies.[388] Each of the above scenarios will be discussed in more detail later in this chapter.

Before one can turn one's attention to the discussion of the anti-avoidance provisions, one must first examine the definitions of the key terms that one will encounter throughout this section. For purposes of the proceeding discussion, the following are the most important terms:

1. settlement;

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[382] Maston *Tolley's UK Taxation of Trusts 2018-19* para 23.1.
[383] Section 619 of the Income Tax (Trading and Other Income) Act 2005.
[384] Section 619(2).
[385] Section 619(2).
[386] Section 619(2).
[387] Section 646.
[388] Section 622.

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2. settlor; and
3. income arising under a settlement.

The definitions discussed below are the meanings used and interpretations followed for determining a settlor's income tax liability, where the operation of the settlor charging provisions treats income as that of the settlor. Unfortunately, there are no general definitions for income tax purposes. It should be noted that the definitions used in the context of other taxes may differ from the below.

Settlement is defined to include "any disposition, trust, covenant, agreement, arrangement or transfer of assets ...".[389]

According to Her Majesty's Revenue and Customs ("HMRC") the definition of settlement is not only limited to arrangements that concern spouses and minor children, but has a much wider ambit.[390] This means that any arrangement that provides for income to be payable to a person other than the settlor will constitute a settlement. However, if the nature of the arrangement is:

1. bounteous; or
2. not commercial; or
3. not at arm's length; or
4. an outright gift between spouses, wholly or substantially a right to income,

the arrangement will only constitute a settlement if the settlor has an interest in the settlement.[391] Based on the definition, it is evident that a settlement is defined in such broad terms that it includes much more than just a trust.[392] However, the definition excludes charitable loans.[393] Similarly, a will is not regarded as a settlement.[394] In addition, it is important to note that a settlement requires the settlor to give a bounty. Hence, commercial arrangements will fall outside the ambit of the definition.[395]

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[389] Section 620(1).
[390] HM Revenue & Customs "Trusts, Settlements and Estates Manual" (08-12-2022) *HMRC* <https://www.gov.uk/hmrc-internal-manuals/trusts-settlements-and-estates-manual/tsem4200> (accessed 19-02-2022).
[391] HM Revenue & Customs "Trusts, Settlements and Estates Manual" (08-12-2022) *HMRC*.
[392] Booth *Booth and Schwarz: Residence, Domicile and UK* 16.
[393] Section 620(1) of the Income Tax (Trading and Other Income) Act 2005.
[394] Chamberlain & Whitehouse *Trust Taxation* 115.
[395] *IRC v Plummer* [1979] STC 793.

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In light of the above, it is clear that the meaning of settlement in the income tax context is defined much wider than the definition of settlement that is used for CGT purposes, where it has a much narrower meaning.[396] A settlor is defined as "any person by whom the settlement was made."[397]

The above statement on its own does not provide much insight. Instead, if read separately, it appears to be a circular reference. However, if one elaborates on the meaning of person in this context, the circumstances under which a person will be regarded as a settlor in relation to a settlement becomes clear. Thus, the definition of settlor must be understood as being a person who:

1. has made or entered into the settlement directly or indirectly;
2. has provided or undertaken to provide funds directly or indirectly for the purposes of the settlement; or
3. has made with any other person a reciprocal arrangement for that other person to make or enter into a settlement.[398]

The definition of settlor is very broad, it aims to cover all parties that are involved in the creation or financing of the settlement. The definition also extends to include indirect parties, or so-called shadow settlors. It is phrased in such a way as to limit the potential for abuse by parties that attempt to structure an arrangement in a manner that circumvents the ambit of the definition.

It is possible for a settlement to have more than one settlor. In such a case, each settlor is treated as the only settlor of a deemed separate settlement.[399] There are specific rules that determine the property and income which is to be treated as belonging to that separate settlement.[400]

The phrase income arising under a settlement is defined as:

> "include—
>
> (a) any income chargeable to income tax by deduction or otherwise, and

[396] Chamberlain & Whitehouse *Trust Taxation* 115.
[397] Section 620(1) of the Income Tax (Trading and Other Income) Act 2005.
[398] *Mills v IRC* [1974] STC 130 HL.
[399] Section 644 of the Income Tax (Trading and Other Income) Act 2005.
[400] Section 645.

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(b) any income which would have been so chargeable if it had been received in the United Kingdom by a person domiciled and resident there."[401]

The definition extends to include all income chargeable to tax on a UK resident from sources within or outside the UK. In other words, if the income that arise under a settlement would have incurred a tax charge if a UK resident received it, it will also constitute income for purposes of this section.

If the settlor is not resident in the UK, any foreign source income is excluded from the ambit of the definition unless it is remitted to the UK, and the income in question would have been subject to tax if it was received directly by the settlor.[402] In such a case, the foreign source income is included in the income arising under a settlement in the year that said income is remitted to the UK.[403] However, the inclusion is limited to the extent of the income that is actually remitted.

Although the definition uses the word "includes", the context suggests that the definition is exhaustive and not open ended. Therefore, it is more appropriate that the definition is read to understand "means" instead of includes.

5 3 1 1 The settlor retains an interest in the income

Section 624 forms part of the greater anti-avoidance provisions, which target arrangements whereby settlors circumvent their tax liability or unduly reduce their tax charge by using income-splitting structures.[404] In such instances, the operation of these provisions deems the income that arises under the settlement to be that of the settlor and assesses the settlor accordingly.

The provision is aimed at the situation where the settlor retains an interest in the property, but the income of said property is paid to someone else.[405] Typically in these arrangements the other person would be someone that falls in a lower tax band than the settlor, or someone that falls below the tax threshold.[406]

The relevant section reads as follows:

[401] Section 648(1).
[402] Section 648(3).
[403] Section 648(5).
[404] Maston *Tolley's UK Taxation of Trusts 2018-19* para 5.11.
[405] Section 624 of the Income Tax (Trading and Other Income) Act 2005.
[406] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.21.

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"(1) Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone if it arises—

(a) during the life of the settlor, and

(b) from property in which the settlor has an interest.

(1A) If the settlement is a trust, expenses of the trustees are not to be used to reduce the income of the settlor."[407]

The operation of this provision treats the income arising under the settlement as if the settlor owned those assets directly. By virtue of the application, the tax treatment of the income arising under the settlement is exactly the same as if the settlor retained said assets in direct ownership.[408] In other words, where a settlor can benefit from a settlement, the provision regards it appropriate to treat the settlement income as still belonging to the settlor and not to the settlement.

However, it is a prerequisite that the income arising under the settlement must be identifiable.[409] If this is not the case, the provision cannot be invoked. Hence, the operation of the provision hinges on the assumption that the income arising under the settlement is identifiable. It is considered that in the majority of cases, the supposition will be true, but in more complicated settlement arrangements, it might not be the case.

If the provision is applicable, its application is limited to income that arises during the life of the settlor.[410] This means that the operation of the provision will cease at the death of the settlor. As a consequence, from that date forward, any income that arise under the settlement will not be attributable to the settlor's estate. There is also nothing to suggest that after the settlor's passing, the liability to tax on the income arising under the settlement will transfer to the settlor's spouse.

Similarly, this is also the case if the settlor originally had an interest in the trust property but is subsequently excluded together with the settlor's spouse from benefiting.[411] Under such circumstances section 624 ceases to apply to income arising after the date that the exclusion took effect. However, if the settlor's exclusion is limited to only a part of the trust fund, then the settlor will only be subjected to tax on the

[407] Section 624 of the Income Tax (Trading and Other Income) Act 2005.
[408] Chamberlain & Whitehouse *Trust Taxation* 33.
[409] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.24.
[410] Section 624(1)(a) of the Income Tax (Trading and Other Income) Act 2005.
[411] Maston *Tolley's UK Taxation of Trusts 2018-19* para 5.11.

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income arising from the remaining portion in which the settlor or the settlor's spouse still has an interest.

If the settlement in question is a trust, subsection (1A) prohibits trustee expenses from being deducted from the income arising under the settlement, before the income is attributed to the settlor.[412] This means that the amount deemed to be that of the settlor is the gross amount received by the trust. This follows from the fact that it is the income arising that is deemed to be the settlor's, which is also the gross amount from which the trustees may pay expenses.[413] There is thus no opportunity to reduce the settlor's tax liability by subtracting expenses. This limitation is important, because in circumstances where section 624 does not apply, the deduction of trustee expenses does reduce the income of a life tenant.[414]

However, before the provision can apply, one must ascertain whether the key requirement has been satisfied. The provision provides that the income arising under the settlement is treated as that of the settlor, but only if the settlor has an interest in the property from which the income is derived.[415] In other words, the operation of the provision is subject to the settlor having an interest in the property. Section 625 outlines the circumstances under which this requirement will be met.[416]

The relevant section reads as follows:

> "(1) A settlor is treated for the purposes of section 624 as having an interest in property if there are any circumstances in which the property or any related property—
> (a) is payable to the settlor or the settlor's spouse or civil partner,
> (b) is applicable for the benefit of the settlor or the settlor's spouse or civil partner, or
> (c) will, or may, become so payable or applicable."[417]

Aside from the situation where the settlor or the settlor's spouse receives direct payments from the settlement, the settlor will also have an interest in the property if the income is used for the benefit of the settlor or the settlor's spouse.[418] The provision

[412] Section 624(1)A of teh Income Tax (Trading and Other Income) Act 2005.
[413] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.21.
[414] Para 33.21.
[415] Section 624(1)(b) of the Income Tax (Trading and Other Income) Act 2005.
[416] Section 625.
[417] Section 625.
[418] Booth *Booth and Schwarz: Residence, Domicile and UK* 145.

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further extends to cases where the trust fund reverts to the settlor under a revocable settlement, or the settlor is a discretionary beneficiary, or even if the ability exists that the settlor could be added as such.[419] However, it has been held that a settlor's power to participate in the management of the trust, is not sufficient to constitute an interest in the settlement. likewise, the possibility that a beneficiary might make a gift to the settlor sometime in the future is irrelevant.[420] Similarly, HMRC accepts that if the trustees agree to pay the inheritance tax that arises on the creation of the settlement, this does not amount to the retention of an interest.[421]

Pertaining to corporate income, no tax charge arises on the settlor under section 624 if the only income in the trust structure arises in a company owned by the trust. This means that the income generated by the company does not constitute settlement income, unless the settlor had given property directly to the company when owned by the trust. Only in such a case, can the income be attributed to the settlor, since such an arrangement will fall within the definition of settlement.[422]

In addition, a trust is not settlor interested merely because:

1. The trustees may lend to the settlor, or purchase an asset from the settlor, on commercial terms; or
2. The trustees do lend to the settlor, or purchase an asset from the settlor, on commercial terms.[423]

Even though each of the above transactions involves a payment to the settlor, either in the form of the money lent or for the purchase price of an asset, it does not create an interest in the settlement. This can be explained by the interpretation of the wording used in the provision. The word "payable" in section 625(1)(a) means payable in a manner conferring a benefit.[424] For this reason, it is necessary to have an additional provision dealing with capital sums paid to the settlor. To this extent, section 633 will be discussed later in this chapter.[425]

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[419] Chamberlain & Whitehouse *Trust Taxation* 33.
[420] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.21.
[421] HM Revenue & Customs "Trusts, Settlements and Estates Manual" (08-12-2022) *HMRC*.
[422] Section 620(1) of the Income Tax (Trading and Other Income) Act 2005.
[423] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.21.
[424] Section 625(1)(a) of the Income Tax (Trading and Other Income) Act 2005.
[425] Section 633.

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Where beneficial loans and guarantees are concerned, the question is much more complicated. As a point of departure, such arrangements raise the following questions:[426]

1. Is the lender/guarantor a settlor by virtue of the loan/guarantee?
2. If this is the case, what property has the lender/guarantor provided?
3. Does the lender/guarantor have an interest in the trust property as a result of the loan/guarantee?

The first question generally arises only if the lender/guarantor is not the original settlor, although it could also arise in circumstances where there is a possibility that the settlor has provided additional property to the settlement, which results in the settlement being tainted. Similarly, the third question is not relevant if the lender/guarantor already has an interest in the trust property.

In order to ascertain under what circumstances such arrangements will result in the trust being settlor interested, one must consider various scenarios. The fact is that there are many permutations, which adds to the complexity. The different configurations may include situations where the settlor borrows from the trust, or where the trust borrows from the settlor or where the lender/guarantor is neither the settlor, nor the trust. Thus, it can be that a third party makes the loan. In broad terms, one must distinguish between the following categories:

1. interest-free loans;
2. beneficial loans; and
3. commercial loans.

Although guarantees are not the same as loans, the issues overlap. This makes it appropriate to also briefly discuss whether the existence of a guarantee will trigger the operation of section 624, as well as if there are circumstances under which the provision will apply in this context.[427]

In *Jenkins v IRC* ("*Jenkins*"),[428] the Court of Appeal found that the making of an interest-free loan to a settlement is enough to constitute an interest in income. Even though the case dealt with the preceding section to that of section 624, the foregoing

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[426] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.21.
[427] Section 624 of the Income Tax (Trading and Other Income) Act 2005.
[428] TC Memo 1983-667.

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provision contained an extended definition of retaining an interest in income that is in similar terms to the definition found in section 624. Hence, the effect of the decision in the *Jenkins* case remains relevant. It was that the settlor who has made an interest-free loan to the trust has brought himself within the ambit of section 624. However, there will be no tax charge unless income actually arises to the trustees.

According to *Wachtel v IRC*,[429] The same applies if the settlor lends on terms which are beneficial to the trust, but not interest-free. An example of the aforesaid is a loan at less than market-related interest.

The converse is also true, if a settlor extends a loan to the trust, but charges market-related interest, such arrangement will not create an interest in income. In other words, if the loan is on commercial terms, the settlor will not be caught by the working of the provision by virtue of the loan. This can be explained by the notion that repayments of such a loan is not a benefit.

In the instance that someone other than the original settlor lends interest-free to a trust, the mere existence of the loan makes the lender a settlor, notwithstanding the fact that said person had no other link to the settlement.[430] This creates a situation where the trust has two settlors, the original settlor and the lender. If the income originating from the interest-free loan can be identified, the lender will be assessed on the income originating from the lender.

Similarly, if someone other than the original settlor makes a beneficial loan to the trust, said person will also become a settlor of that trust.[431] This means even a loan that is not interest free but at a low rate of interest, will still result in an unrelated lender becoming a settlor in relation to said trust. However, only if the income originating from the lender can be identified, will the lender be liable to tax on said income.

Where guaranties are concerned, if the settlor guarantees a loan or other obligation of the trustees, the trust is not settlor interested.[432] This means the mere existence of a guarantee is not sufficient to make the trust settlor interested. Moreover, A guarantor's claim against a solvent trust would only arise if the trustees failed to meet their primary contractual obligations.

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[429] 46 TC 543.
[430] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.17.
[431] Para 33.17.
[432] Para 33.17.

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This is also the case if it is someone other than the settlor that provides the guarantee to the trust.[433] In such scenario, the guarantor would not fall within the ambit of section 624, unless the following conditions are complied with:

1. income originating from the guarantor must be identifiable; and
2. the guarantor had an interest in that income under the trust.

This means that only if the income originating from the guarantor is identifiable and if the guarantor had another interest under the trust, which is unrelated to the guarantee, will the guarantor be assessed on the income. Thus, the existence of the guarantee alone does not constitute an interest.

Section 625 further outlines the circumstances under which the attribution rule contained in section 624 will not be applicable, even if all the other requirements have been satisfied. The exceptions cover instances where the settlor obtains an interest in property that was originally settled by the settlor or an interest in property derived from said property, through inadvertence or due to circumstances which are likely to be outside the settlor's control.[434]

The relevant section reads as follows:

> "(2) Subsection (1) does not apply if the only circumstances are one or more of—
>
> (a) the bankruptcy of a person who is, or may become, beneficially entitled to the property or any related property,
>
> (b) the assignment of the property or any related property by such a person,
>
> (c) the charging of (or, in Scotland, the granting of a right in security over) the property or any related property by such a person,
>
> (d) in the case of a marriage settlement or civil partnership settlement, the death of both parties to the marriage or civil partnership and of all or any of the children of the family of the parties to the marriage or civil partnership, and
>
> (c) the death of a child of the settlor who had become beneficially entitled to the property or any related property at not more than 25 years old."[435]

In addition to the aforesaid, the provision will also not apply in the circumstances that the settlement is structured in such a way that the property cannot be applied for the

[433] Para 33.17.
[434] Section 625 of the Income Tax (Trading and Other Income) Act 2005.
[435] Section 625.

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benefit of the settlor unless a specific event materialises. In such a case, the settlement will revert back to the settlor on the occurrence of said event. However, the caveat to this exception is that it is only available while the person is under the age of 25.[436]

The relevant section reads as follows:

> "(3) Subsection (1) does not apply if—
>
> (a) there are no circumstances in which the property or any related property can become payable or applicable as mentioned in that subsection during the life of a person other than—
>
> (i) the bankruptcy of the person, or
>
> (ii) the assignment or charging of the person's interest in the property or any related property, and
>
> (b) the person is alive and under 25 years old."[437]

Besides the aforementioned exceptions, the proceeding sections make provision for a range of circumstances under which the provision is not applicable. Presumably, these exceptions align with government's policy position and those scenarios where government regards the use of settlements as acceptable. In order to encourage such conduct, it is not appropriate to burden the settlor with the tax charge on the income that arises under the settlement. These exceptions fall outside the scope of this dissertation and will thus not be discussed. However, among others, provision is made for the following:

1. outright gifts between spouses;[438]
2. maintenance arrangements;[439]
3. commercial payments;[440]
4. qualifying donations;[441]
5. pension benefits;[442]
6. payments to charities; and[443]

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[436] Section 625(3).
[437] Section 625(3).
[438] Section 626.
[439] Section 627(1).
[440] Section 627(2)(a).
[441] Section 627(2)(b).
[442] Section 627(2)(c).
[443] Section 628.

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7. protected foreign source income.[444]

If the settlor is a non-resident, UK source trust income is within the scope of section 624, but foreign income is not.[445] In such case, the trustees are taxed in full on foreign source income. If section 624 also applied to the foreign source income, it may give rise to a situation where the operation of the anti-avoidance rule actually benefits the settlor. However, the settlor is still taxed on UK source income. This is beneficial if the settlor's marginal rate is less than the top rate of income tax, or if the non-resident's relief applies.[446]

The relevant section reads as follows:

> "(2) But if, in a tax year, the settlor is not UK resident, references in this Chapter to income arising under a settlement do not include income arising under the settlement in that tax year in respect of which the settlor, if actually entitled to it, would not be chargeable to income tax by deduction or otherwise because of not being UK resident." [447]

In the instance that both the trust and the settlor are non-resident, neither the trustees nor the settlor is taxed on foreign source income.[448] In such case, the settlor is still liable to tax on UK source income. This can be beneficial if the settlor's marginal rate is less than the top rate of income tax, or if non-residents tax relief is available to the settlor and not to the trustees.[449]

Where non-resident settlors are concerned, no tax charge will arise on income that arose under the settlement while the settlor was non-resident if said income is subsequently remitted after the settlor became a resident.[450] In other words, if foreign income arises to the trustees of a settlor-interested trust while the settlor is non-resident, but the income is only remitted by the trustees when the settlor is resident and a remittance basis taxpayer, the income that arose during the period that the settlor was non-resident will not be caught by the operation of section 624. This

[444] Section 628A.
[445] Section 648.
[446] Maston *Tolley's UK Taxation of Trusts 2018-19* para 5.12.
[447] Section 648(2) of the Income Tax (Trading and Other Income) Act 2005.
[448] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 12.18.
[449] Maston *Tolley's UK Taxation of Trusts 2018-19* para 5.17.
[450] Para 5.17.

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phenomenon can be explained by the fact that the non-resident period income does not constitute income under the definition of income arising under the settlement.[451]

The relevant section reads as follows:

> "(3) And if, for a tax year, section 809B, 809D or 809E of ITA 2007 (remittance basis) applies to the settlor, references in this Chapter to income arising under a settlement include in relation to any relevant foreign income arising under the settlement in that tax year only such of it as is remitted to the United Kingdom (in that tax year or any subsequent tax year) in circumstances such that, if the settlor remitted it, the settlor would be chargeable to income tax.
>
> (5) Where subsection (3) applies the remitted income is treated for the purposes of this Chapter as arising under the settlement in the tax year in which it is remitted."[452]

It may seem at first glance that the non-resident period income is subjected to the working of section 624, as it is treated under section 648(5) as arising in the year of remittance. However, such an interpretation is incorrect. This follows from the fact that the circumstances are not "such that, if the settlor remitted the non-resident period income, the settlor would be chargeable to income tax". Unless the settlor is UK resident when the income arises, the settlor would not be taxed on said income when remitted later, even if it had been the settlor's income all along. Furthermore, the non-resident period income is not "income arising under the settlement" by virtue of section 648(2). Hence, the result is sensible and consistent with the rule that the income of an individual arising during a non-resident period is not taxable if remitted during a resident period.[453] For this reason, it is advisable that trust income arising prior to the settlor becoming a UK resident should be segregated from income arising subsequently, whether it is retained in the trust or distributed to the settlor.

5 3 1 2 Payments to the settlor's child

Section 629 is an anti-avoidance provision, which targets the situation where a settlor makes a settlement in favour of the settlor's minor child.[454] The provision is aimed at

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[451] Section 648 of the Income Tax (Trading and Other Income) Act 2005.
[452] Section 648(3) and (5).
[453] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 12.18.
[454] Section 629 of the Income Tax (Trading and Other Income) Act 2005.

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preventing income splitting between parents and their minor children. By the application of this provision, income that arises under a settlement is deemed to be that of the settlor and accordingly taxed in the settlor's hands.[455]

The relevant section reads as follows:

> "(1) Income which arises under a settlement is treated for income tax purposes as the income of the settlor and of the settlor alone for a tax year if, in that year and during the life of the settlor, it—
>
> (a) is paid to, or for the benefit of, a relevant child of the settlor, or
>
> (b) would otherwise be treated (apart from this section) as income of a relevant child of the settlor."[456]

If the provision applies, it deems the income that arises under the settlement to be that of the settlor parent. Thus, for tax purposes, the settlor is treated as if the settlor has received said income directly, notwithstanding the fact that the income had been received by or accrued to the minor or had been expended or accumulated for the child's benefit.[457]

This means that income produced by a settlement, which is paid during the settlor's lifetime to or for the benefit of the settlor's minor unmarried child is taxed as the income of the settlor in the tax year when it is distributed. The provision will operate until either the minor child obtains the age of majority or until the death of the settlor, whichever event occurs first.[458]

However, the operation of the provision is subject to section 624. Hence, if the income that arises under the settlement is already deemed to be that of the settlor by virtue of section 624, the provision cannot apply.[459] In other words, if the settlor retains an interest in the property, the application of section 624 will take preference over that of section 629.

In addition, the provision is only applicable if the total amount paid to the child under such settlement exceeds £100 in the year of assessment.[460] This means that

[455] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.63.
[456] Section 629(1) of the Income Tax (Trading and Other Income) Act 2005.
[457] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.63.
[458] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.13.
[459] Section 629(2) of the Income Tax (Trading and Other Income) Act 2005.
[460] Section 629(3).

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the provision does not apply in instances where the £100 threshold is not breached. The £100 limitation is available to each parent settlor.

For purposes of calculating the £100 limit, all income that is paid to the child or expended for the child's benefit must be included.[461] Thus, it is not just restricted to direct payments, but also extends to indirect benefits.

The relevant section reads as follows:

"(2) Subsection (1) does not apply to income which is treated as income of the settlor under section 624.

(3) Subsection (1) does not apply in relation to a child's relevant settlement income in any tax year if, in that year, the total amount of that income does not exceed £100.

(4) In subsection (3) a child's "relevant settlement income" means income—

(a) which is paid to or for the benefit of, or otherwise treated as income of, the child, and

(b) which (apart from subsection (3)) would be treated as income of the settlor under subsection (1)."[462]

In the context of this provision, child is widely defined to include a stepchild, an illegitimate child, and an adopted child, but does not include a foster child.[463] Neither does the working of the provision extend to a grandchild. Consequently, if the settlor is not the parent of the child beneficiary, the above provisions do not apply. Thus, depending on the circumstances, settlements funded by grandparents can be advantageous from an income tax point of view.

The relevant section reads as follows:

"(7) In this section and sections 631 and 632—

(a) "child" includes a stepchild,

(b) "minor" means a person under the age of 18 years, and "minor child" is to be read accordingly, . . .

(c) references to payments include payments in money's worth, and

[461] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.13.
[462] Section 629(1) of the Income Tax (Trading and Other Income) Act 2005.
[463] Section 629 subs (7).

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(d) "relevant child" means a minor child who is unmarried or not in a civil partnership."[464]

It is important to note that there must be no power to terminate the trust in circumstances where the fund could revert to the settlor. Otherwise, the settlor will be taxed on the income that arises under the settlement in terms of section 624 as a settlement in which he has retained an interest.[465] It is immaterial whether the power to terminate is given to the settlor or to a stranger. The only factor that matters is that the settlement must be irrevocable. A settlement is not irrevocable if it can be determined by act or default of any person.[466]

Furthermore, to ensure that the settlement income is not caught by section 624, the terms of the settlement must stipulate that the income or assets from the settlement must not be payable, to or for the benefit of the settlor or the settlor's spouse, except for payments made after the death of the child beneficiary or on the bankruptcy of the child, or on a purported charge or assignment of assets by the child.[467] If this is not the case, the settlement will be regarded as settlor interested, and will subsequently be taxed in the settlor's hands by virtue of section 624.

However, there are various exceptions to the application of the provision. The following sections make provision for a range of circumstances under which the provision is not applicable. The exceptions available under section 629 is much more limited than those provided for section 624. Notwithstanding the aforesaid, the exceptions overlap. For this reason, it is evident that the government would like to encourage settlements for such purposes while discouraging the use of settlements for other objectives. These exceptions fall outside the scope of this dissertation and will thus not be further discussed. It is sufficient to state that provision is made for the following scenarios:

1. payments to charities;[468] and
2. protected foreign source income.[469]

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[464] Section 629 subs (7).
[465] Section 624.
[466] Booth *Booth and Schwarz: Residence, Domicile and UK* 247.
[467] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.13.
[468] Section 630 of the Income Tax (Trading and Other Income) Act 2005.
[469] Section 630A.

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In the instance that income is accumulated under an irrevocable settlement of capital for a minor child, the income is not taxed as that of the settlor.[470] However, if payments are later made out of the trust fund to the child, while the child is still under 18 and unmarried, such distributions are treated as the settlor's income up to the amount of the accumulated income.[471] Under such circumstances, the payment is not taxable in the minor child's hands. This follows from the fact that the trustees will have already accounted for tax at the relevant rate in the year the income arose. The tax rate ultimately chargeable on the settlor depends on when it is paid to the child. It is chargeable at the settlor's marginal rates and carries a credit for the tax paid by the trustees.[472]

The relevant section reads as follows:

> "(1) This section applies if—
> (a) the trustees of a settlement retain or accumulate income arising under the settlement, and
> (b) a payment is subsequently made in connection with the settlement to, or for the benefit of, a child of the settlor who is unmarried or not in a civil partnership.
> (2) The payment is treated for the purposes of section 629(1) as a payment of income, but only so far as there is retained or accumulated income available.
> (3) For the purposes of subsection (1) a payment is made in connection with a settlement if it is made by virtue of or in consequence of—
> (a) the settlement, or
> (b) any enactment relating to the settlement."[473]

5 3 1 3 Capital sums paid to settlor

Section 633 is another anti-avoidance provision in HMRC's arsenal against tax avoidance by the use of trusts. While section 624 focused on instances where the settlor retained an interest in the property,[474] and section 629 targeted the situation where a settlement is intended to benefit the settlor's minor child,[475] section 633 is

[470] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.13.
[471] Section 631 of the Income Tax (Trading and Other Income) Act 2005.
[472] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.63.
[473] Section 631 of the Income Tax (Trading and Other Income) Act 2005.
[474] Section 624.
[475] Section 629.

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aimed at preventing the settlor from obtaining any benefit from the settlement by exploiting the differences in the tax rates applicable to the settlor and the trust.[476] In such case, the provision deems the capital payments received from the trust as the income of the settlor and said income is subsequently taxed in the settlor's hands. However, in most cases, the provision will only apply to non-settlor-interested trusts.[477]

The provision targets the situation where the trustees of a settlement make capital payments to the settlor of said settlement.[478] The capital benefits in question are made out of undistributed trust income. This means the trustees have already paid tax on the accumulated income as it arose, which is then being distributed to the settlor in a later tax year. The problem with the aforesaid, is that the tax rate applicable to the settlor may be substantially higher than the rates applicable to the trust.[479] If the provision did not exist, such capital sums would have been received tax free in the settlor's hands, which will result in the settlor paying less tax than would have been the case if the income was received directly by the settlor. But the operation of this provision treats such capital payments as the settlor's income and is taxed accordingly.

The relevant section reads as follows:

"(1) Any capital sum paid directly or indirectly in any tax year by the trustees of a settlement to the settlor is treated for income tax purposes as follows.

(2) The sum is treated as the income of the settlor for the tax year so far as the amount of the sum falls within the amount of income available up to the end of the year.

(3) The sum is treated as the income of the settlor for the following year so far as the amount of the sum—

(a) is not treated under subsection (2) as the settlor's income for the tax year in which it is paid, and

(b) falls within the amount of the income available up to the end of the following year.

(4) Subsection (3) also applies for each subsequent year up to a maximum of 10 years subsequent to the tax year in which the sum is paid.

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[476] Section 633.
[477] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.12.
[478] Maston *Tolley's UK Taxation of Trusts 2018-19* para 4.26.
[479] Para 4.26.

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(5) For this purpose the reference in subsection (3)(a) to being treated under subsection (2) as the settlor's income for the tax year in which the capital sum is paid is a reference to being treated under subsection (2) or (3) as the settlor's income for that year and any other year before the subsequent year in question."[480]

Over the last few years, the tax rates applicable to discretionary trusts and that of individual taxpayers have been normalised, which resulted in the provision becoming largely redundant for UK resident discretionary trusts.[481] Currently, the marginal tax rate for both discretionary trusts and natural persons is set at 38,1% for dividend income and 45% for all other income.[482] This means that when capital payments are matched to trust income the notional tax credit is usually equal to the potential liability of the settlor and no further tax will be due. However, this will not be the case for accumulated income that arose prior to the amendment of the tax rates.

Notwithstanding the aforesaid, the provision is relevant where the trust is not settlor interested and capital benefits to the settlor are matched to trust income that has been taxed at a lower rate or if the trust is non-UK resident when no tax will have been paid on non-UK source income.[483]

If the provision is invoked, the provision treats the capital payments, which are made from the trust's accumulated income by the trustees to the settlor or the settlor's spouse, as the income of the settlor for tax purposes. In such a case, the settlor will be assessed on the capital sum received, but the taxable amount for that year will be limited to the available income in the trust for that year of assessment.[484] This means that the portion of the capital sum that is taxable in the settlor's hands for that year depends on the amount of undistributed income in the trust. The remainder of the capital amount that was not subjected to tax is rolled over to the next tax year. In the year following the capital distribution, a part of the untaxed amount is once again added to the settlor's income for that year of assessment, but only to a maximum amount equal to the available income in the trust.[485] This process will continue until the entire capital sum has been taxed in the settlor's hands, or for a period of ten years

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[480] Section 631 of the Income Tax (Trading and Other Income) Act 2005.
[481] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.1.
[482] Para 31.3.
[483] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.44.
[484] Section 633 subs (2) of the Income Tax (Trading and Other Income) Act 2005.
[485] Section 633 subs (3).

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subsequent to the year in which the capital payment was made.[486] If there is still an unutilised portion remaining after the ten-year period has laps, that part of the capital payment will fall away and no further tax liability will ensue.

Unlike in the case of section 624 and section 629, which deals with taxing the settlor on trust income where the settlor retains an interest,[487] or where trust payments are made to the settlor's child, respectively,[488] under section 633, the settlor has no right of recovery for the tax liability that follows from the capital distribution. This means the settlor cannot recover said tax from the trustees or beneficiaries.

Despite the terminology used, the provision seldomly applies to capital sums, since in non-settlor-interested trusts, the settlor and the settlor's spouse would be excluded as a beneficiary under the trust.[489] This means the trustees would not have the power to make capital payments to the settlor or the settlor's spouse.

The provision only applies if the capital payment received by the settlor from the trustees of the settlement constitutes a capital sum.[490] For purposes of this provision, section 634 outlines the definition of capital sums.[491] Section 634 further contains certain exceptions under which the provision will not apply.[492]

The relevant section reads as follows:

"(1) In this Chapter "capital sum" means—

(a) any sum paid by way of loan or repayment of a loan, and

(b) any other sum which—

(i) is paid otherwise than as income, and

(ii) is not paid for full consideration in money or 'money's worth.

(2) But this is subject to subsections (3) to (6).

(3) It does not include any sum which could not have become payable to the settlor except—

(a) in one of the circumstances mentioned in subsection (2) of section 625, or

(b) on the death under the age of 25 of any person of the kind mentioned in subsection (3) of that section.

[486] Section 633 subs (4).
[487] Section 624.
[488] Section 629.
[489] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.3.
[490] Section 633 subs (1) of the Income Tax (Trading and Other Income) Act 2005.
[491] Section 634 subs (1).
[492] Section 634 subs (3).

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(4) It does include a sum treated as a capital sum by subsection (5) below.

(5) Any sum which—

(a) is paid by the trustees of a settlement to a third party—

(i) at the settlor's direction, or

(ii) as a result of the assignment by the settlor of the settlor's right to receive the sum, or

(b) is otherwise paid, or applied by, the trustees for the benefit of the settlor, is treated as a capital sum paid to the settlor by the trustees.

(6) Subsection (5) does not apply to any sum which would, apart from that subsection, be treated as a capital sum paid to the settlor.

(7) References in sections 633 to 638 to sums paid to the settlor include references to sums paid to—

(a) the spouse or civil partner of the settlor, or

(b) the settlor (or the spouse or civil partner of the settlor) jointly with another person."[493]

The provision is typically encountered where the settlement makes a loan to the settlor or the settlor's spouse. Strangely enough, the provision also applies in the situation where the settlor or the settlor's spouse provides a loan to the settlement, which is then subsequently repaid to the settlor.[494] By virtue of the provision, the repayment of the loan by the trustees is treated as the payment of a capital sum to the settlor. For purposes of the provision, the terms of the loan are irrelevant. This means that it makes no difference whether the loan was interest free or on full commercial terms.[495]

The provision does not apply if the capital payment is otherwise than by way of a loan or repayment of a loan and is for full consideration in money or money's worth.[496] This means that a purchase by the trustees from the settlor or settlor's spouse of an asset at full value will not be caught by the provision.

Section 633 further incorporates the exceptions found in section 625(2) and section 625(3) into the provision. This means that section 633 will also not apply under any of the aforesaid circumstances.[497]

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[493] Section 634.
[494] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.44.
[495] Para 25.44.
[496] Section 634 subs (1) of the Income Tax (Trading and Other Income) Act 2005.
[497] Section 634 subs (3).

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In addition, a capital sum is treated as paid to the settlor if it is paid to a third party at his direction or as a result of his assignment, but is only caught to the extent that it is less than, or equal to, the income available in the settlement.[498]

Before one can determine the settlor's tax charge, one must ascertain the available income under the trust for that tax year. Section 635 provides the formula that must be used in this calculation.

The relevant section reads as follows:

> "(1) For the purposes of section 633 the amount of income available up to the end of any tax year is, in relation to any capital sum paid as mentioned in subsection (1) of that section by the trustees of a settlement, calculated as follows.
>
> (2) Add together the amount of unprotected income arising under the settlement in that year and any previous year which has not been distributed.
>
> (3) Deduct from that figure—
>
> (a) the amount of that income taken into account under section 633 in relation to that sum in any previous year or years,
>
> (b) the amount of that income taken into account under section 633 in relation to any other capital sums paid to the settlor in any year before that sum was paid,
>
> (c) any income arising under the settlement in that year or any previous year which has been treated as income of the settlor under section 624 or 629, and
>
> (d) an amount equal to the sum of tax at the trust rate on—
>
> (i) the total amount of unprotected income arising under the settlement in that year and any previous year which has not been distributed, less
>
> (ii) any income of the kind mentioned in paragraph (c)." [499]

For purposes of calculating the available income under the trust, one must first get the sum of all the unprotected income that has not been distributed.[500] This means all protected foreign source income must be disregarded.

Second, one must subtract all the income that has already been taxed in the settlor's hands in terms of either section 624 and section 629.[501] This means that not

[498] Section 634 subs (5).
[499] Section 635.
[500] Section 635 subs (2).
[501] Section 635 subs (3)(c)(c).

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only is the operation of section 633 subject to the aforesaid two provisions, but section 624 and 629 takes preference over the working of section 633.

After the above steps are complete, one must deduct any amounts that have already been subjected to tax under section 633, pertaining to either the capital sum in question[502](158) or for any capital sum previously paid to the settlor.[503] Finally, the tax charge on all the income that arose under the settlement, or that arose in previous years but was not distributed must be subtracted from the remainder sum.[504] However, the protected foreign source income and the income already taxed under the other provisions are excluded from the tax charge calculation. The income of the aforesaid steps is the available income under the trust for that year of assessment.

When the available income under the trust is matched to the settlor, the income that was first accumulated in the trust, is used before any subsequent income.[505] In other words, the assignment of income works in chronological order. This means that income that arose in earlier years are utilised before income that arose in later tax years. However, this phenomenon may give rise to a situation where income that was taxed at a lower rate is used first for the calculation, which results in a bigger tax liability for the settlor. This can be the case, notwithstanding the fact that there may be significant trust income in later years that has been taxed at higher rates.[506]

By virtue of the provision, the capital sum is treated as income of the settlor grossed up at the trust rate applicable in the year of the capital receipt.[507] This is irrespective of the personal tax position of the settlor or the source of the income. This means the income does not retain its identity when distributed to the settlor. Therefore, the settlor is not able to use the tax rates applicable to that specific type of income, but instead, all the income is grossed up at the trust's tax rate.[508]

The relevant section reads as follows:

[502] Section 635 subs (3)(a)
[503] Section 635 subs (3)(b).
[504] Section 635 subs (3)(d).
[505] Maston *Tolley's UK Taxation of Trusts 2018-19* para 4.31.
[506] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 31.2.
[507] Section 640 subs (1) of the Income Tax (Trading and Other Income) Act 2005.
[508] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.53.

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"(1) The whole or any part of a capital sum which is treated under section 633 as income of the settlor for any tax year is treated as income of an amount equal to the sum or the part of the sum, grossed up by reference to the [trust rate for that year].

(2) The deductible amount is to be set off against the amount of tax charged on any amount treated under section 633 as income of the settlor for any year.

(3) In subsection (2) the "deductible amount" is an amount equal to—
   (a) tax at the [trust rate for the year on the amount treated under section 633 as the settlor's income],
   (b) so much of the amount of tax at that rate as is equal to the tax charged, or
   (c) the amount of tax paid by the trustees on the grossed-up amount of so much of the amount of income available up to the end of the year, in relation to the capital sum, as is taken into account under section 633 in relation to that sum in that year (see subsections (4) to (7) below),whichever is the least.

(4) For the purposes of subsection (3)(c)—
   (a) any reduction falling to be made under section 635(3)(d) is treated as made against income arising under the settlement in an earlier tax year before income arising under the settlement in a later tax year, and
   (b) income arising under the settlement in an earlier tax year is treated as taken into account under section 633 before income arising under the settlement in a later tax year.

(5) For the purposes of subsection (3)(c)—
   (a) the grossed-up amount of any sum is an amount equal to the sum, grossed up by reference to the appropriate rate for each part of the sum, and
   (b) the amount of tax paid by the trustees on that grossed-up amount is the difference between the grossed-up amount and the sum in question.

(6) For the purposes of subsection (5)—
   (a) the appropriate rate for any part of a sum is 0% if—
      (i) the income that falls to be treated in accordance with subsection (4) as representing that part of the sum is income from a source outside the United Kingdom, and
      (ii) the trustees were non-UK resident for the relevant tax year, and
   (b) the appropriate rate for any part of a sum in relation to which paragraph (a) does not apply is—
      (i) 34%, if the relevant tax year is the year 2003-04 or any earlier tax year, ...
      (ii) 40%, if the relevant tax year is the year 2004-05 or any subsequent tax year up to and including the year 2009-2010, ...

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(iii) 50%, if the relevant tax year is the year 2010-2011 , 2011-12 or 2012-13, and

(iv) 45%, if the relevant year is the year 2013-14 or any subsequent tax year.

(7) In subsection (6) "the relevant tax year", in relation to any part of a sum, means the tax year in which the income treated in accordance with subsection (4) as representing that part of the sum arose under the settlement." [509]

The section makes provision for the settlor to claim a credit for tax actually paid by the trustees in earlier tax years when the income arose under the settlement.[510] However, if the settlor is a lower rate tax payer than the trust, the settlor is not able to reclaim the difference in the applicable tax rates.

In other words, if the settlor includes the grossed up income, which subsequently results in the settlor becoming a higher or additional rate taxpayer, the settlor will be liable to tax at the marginal rate on that income, but will receive a credit for the tax actually paid by the trustees in earlier years.

This is in contrast to the position encountered under prior provisions, where the settlor is afforded the opportunity to recover any tax paid from the trustees and is taxed by reference to the source of the income and not one fixed rate.[511] This means that in terms of section 633, the settlor will not be able to utilise the benefit of the dividend rate, but will instead be taxed at the higher trust rate.[512]

Following from the above, for all income that arises under a UK discretionary trust in 2013-2014 and any subsequent tax years, the notional tax credit will often fully cover the tax charge on the settlor. However, further tax will be due if the trust had received dividend income during the period in question, or if the payment has to be matched to available income of years prior to 2004-05. This inference is based on the fact that the applicable trust rate for said period was set at 34%,[513] which is substantially lower than the current trust rate of 45%.[514] In contrast to the aforesaid, income that arose under the trust between 2004 and 2013, the settlor will not be able

[509] Section 640 of the Income Tax (Trading and Other Income) Act 2005.
[510] Section 640 subs (3).
[511] Section 646.
[512] Section 633.
[513] Section 640 subs (6)(b)(i).
[514] Section 640 subs (6)(b)(iv).

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to claim the difference of the applicable rates, even though the trust would have paid more tax than what is currently due.

If the trust is non-UK resident, there is no such notional tax relief available to the settlor. In such a case, the settlor could be taxed at 45% by reference to the available trust income, which is grossed up at 0% if the income arises from a non-UK source to a non-UK resident trust.[515] However, if the trust has always been a fixed-interest trust then there is generally no available income anyway against which the capital payment is matched.

In addition to the aforesaid, section 641 expands the ambit of section 633 to also apply to the situation where a capital sum is paid to the settlor by a legal person, which is connected to the settlement.[516] Hence, the provision can apply even if the capital distribution to the settlor was made by someone other than the trust, if the paying party is subsequently reimbursed by the trustees of the settlement.

The relevant section reads as follows:

"(1) This section applies if—

(a) a capital sum is paid to the settlor in a tax year by any body corporate connected with the settlement in that year, and

(b) an associated payment has been, or is, made directly or indirectly to the body by the trustees of the settlement.

(2) The capital sum is, in accordance with this section, treated for the purposes of section 633 as having been paid to the settlor by the trustees of the settlement.

(3) A capital sum to which subsection (2) applies is treated as having been paid to the settlor in the tax year in which it is paid so far as the amount of the sum falls within the total of the associated payment or payments made up to the end of the year.

(4) A capital sum to which subsection (2) applies is treated as having been paid to the settlor in the following year so far as the amount of the sum—

(a) is not treated as paid to the settlor in the year mentioned in subsection (3), and

(b) falls within the total of the associated payment or payments made up to the end of the following year (less what was taken into account under subsection (3) in relation to the sum in the previous year).

(5) Subsection (4) also applies for each subsequent year.

(6) In its application to a subsequent year—

[515] Section 640 subs (6)(a).

[516] Section 641 subs (1).

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(a) the references to the following year are to the subsequent year,

(b) the reference to the year mentioned in subsection (3) is to that year and any other year before the subsequent year, and

(c) the reference to what was taken into account under subsection (3) in relation to the sum in the previous year is to what was taken into account under this section in relation to the sum in the previous years."[517]

5 3 2 Transfer of assets

The transfer of assets regime is a set of anti-avoidance provisions that focuses on arrangements whereby taxpayers shift income-producing assets to foreign entities in order to circumvent UK taxation. Since non-resident trusts and companies are not subject to UK income tax on any income aside from UK source income, and non-resident companies may pay less tax on UK source income, these rules present the opportunity for taxpayers to minimise their tax liability.[518] The provisions do not only apply to a situation where assets are transferred to foreign entities without due consideration but apply even if full consideration is received.[519] By virtue of the provisions, the income that arises under said foreign entity is deemed to be that of the transferer and accordingly taxed in the transferer's hands.[520]

The regime consists of various sections, which collectively operate to curb different forms of transfer arrangements. Each section is aimed at a specific scenario with its own set of requirements. The circumstances under which these provisions are applicable can be divided into the following categories:[521]

1. income payments;
2. capital sums; and
3. provided benefits.

In any of the above cases, the provision treats the income that arises under the foreign entity as that of the transferer for income tax purposes. The operation of the provisions is not limited to only the income that the transferer actually receives, but the ambit extends to instances where a capital disbursement is made, the mere power of

[517] Section 641.
[518] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.1.
[519] Para 36.1.
[520] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.41.
[521] Section 714 of the ITA 2007.

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enjoyment exists and any benefits derived from the transfer.[522] In addition, the provisions are not exclusively targeted at arrangements concerning trusts but rather cover all non-resident entity types.[523] However, the discussion will primarily focus on the application to non-resident trusts. Each of the scenarios to which the provisions apply will be discussed later in this section.

Even though the transfer of assets regime operates alongside the other anti-avoidance mechanisms aimed at trusts, such as the settlor's charging provisions,[524] the working of these regimes and the consequences for taxpayers differ to a certain extent. For one, under the transfer of assets regime, the settlor has no right of recovery against the foreign entity for taxes paid. This is in contrast with the settlor charging provisions, where the settlor is afforded the right to recover the tax incurred from the trustees or from the beneficiaries of the settlement.[525] Secondly, unlike in the case of the settlor's charging provisions, it is not a prerequisite for an element of bounty to be present in the arrangement before the transfer of assets provisions are applicable, as long as the other requirements are satisfied.

Similar to the settlor charging provisions, the income that arises to the non-resident is treated as if the income was received by the transferor directly.[526] This means that the transferer is also afforded the same deductions and reliefs that would have been available if the income was received by the UK resident.

However, the transfer of assets provisions does not apply if the income in question has already been taxed under another provision.[527] In other words, if a non-resident trust is settlor interested, the income arising under the settlement will be taxed in the hands of the settlor by virtue of section 624.[528] In such a case, the transfer of assets provisions will not apply. This means that regardless of the facts of the case, income will never be subjected to tax more than once. If the circumstances are of such nature that both provisions are potentially applicable, the settlor's charging provisions will take preference over the transfer of assets provisions.

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[522] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.1.
[523] Para 36.1.
[524] Chapter 5 of the Income Tax (Trading and Other Income) Act 2005.
[525] Section 646.
[526] Section 746 of the ITA 2007.
[527] Section 743.
[528] Section 624 of the Income Tax (Trading and Other Income) Act 2005.

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For purposes of the discussion that follows, the special rules regarding remittance basis taxpayers will not be examined. Instead, the discussion will be limited to taxpayers that make use of the arising basis.

Before one can analyse the substantive aspects of the provisions, one must first familiarise oneself with the different terms used throughout the section. To this extent, for purposes of the transfer of assets regime, the following terms form the cornerstone of all the charging provisions:

1. relevant transfer;
2. relevant transaction;
3. person abroad; and
4. associated operation.

5 3 2 1 Relevant transaction

A relevant transaction is defined as:

> "(1) A transaction is a relevant transaction for the purposes of this Chapter if it is—
> (a) a relevant transfer, or
> (b) an associated operation."[529]

The definition appears to be nothing more than an umbrella term that encapsulates both a relevant transfer and an associated operation. In other words, if there is a relevant transfer, it is also a relevant transaction. Similarly, if it is an associated operation, it is also a relevant transaction.

It is clear that the above definition does not provide much insight. Instead, one must turn to the definitions for relevant transfer and associated operations.

5 3 2 2 Person abroad

The phrase a person abroad is defined as: "(a) a person who is resident outside the United Kingdom, or (b)an individual who is domiciled outside the United Kingdom."[530]

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[529] Section 715 of the ITA 2007.
[530] Section 718 subs (1).

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It is evident that the definition does not follow the usual terminology convention as one would expect to find in tax statutes.[531] The key term here is outside the UK. This in itself is rather strange. Instead of using the well-used term non-resident, the provision uses novel criteria outside the UK.[532]

It is considered that the terms resident outside the UK and non-resident are not exactly the same. To this extent, a person who is not a UK resident must be resident outside the UK. Similarly, a person who is a UK resident but also resident in another state will be a resident outside the UK.

One can thus observe that all UK residents are excluded from the definition, regardless of where the entities are incorporated or formed. This means that a foreign trust that is UK resident for tax purposes does not constitute a person abroad.

The provision further deems certain persons to be resident outside the UK. This is to resolve the mismatch between the terminologies used. If this was not the case, it could possibly be argued that trustees who are not resident in the UK are not resident anywhere, therefore, they are not resident outside the UK.[533] If this reasoning is followed, none of the transfer of assets provisions can apply.

The relevant section reads as follows:

> "(2) For the purposes of this Chapter, the following persons are treated as resident outside the United Kingdom—
>
> (a) . . .
>
> (b) the person treated as non-UK resident under section 475(3) (trustees of settlements), and
>
> (c) persons treated as non-UK resident under section 834(4) (personal representatives)." [534]

5 3 2 3 Associated operation

The term "associated operations" is one of the key concepts of the transfer of assets regime. It is used in a number of the provisions to qualify a condition of application or to extend the reach of certain concepts.[535] The definition is defined in the widest

[531] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.21.
[532] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.36.
[533] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.21.
[534] Section 718 subs (2) of the ITA 2007.
[535] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 38.38.

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possible terms to include almost any variation or form that is remotely related to the transfer.

The relevant section reads as follows:

> "(1) In this Chapter "associated operation", in relation to a transfer of assets, means an operation of any kind effected by any person in relation to—
>
> (a) any of the assets transferred,
>
> (b) any assets directly or indirectly representing any of the assets transferred,
>
> (c) the income arising from any assets within paragraph (a) or (b), or
>
> (d) any assets directly or indirectly representing the accumulations of income arising from any assets within paragraph (a) or (b).
>
> (2) It does not matter whether the operation is effected before, after or at the same time as the transfer."[536]

The concept associated operation does not exist in isolation, it exists in relation to a transfer. Based on the above definition, one can derive the following requirements for an associated operation to be present:

1. there must be an operation; and
2. the operation must be effected in relation to the assets transferred by the transfer.

Even though the word operation is not defined, it is clearly a word of wide import.[537] For guidance on interpreting the aforesaid, one can consult the case law on this point. Although most of the cases delt with inheritance tax, the interpretations followed are still useful.

In *Congreve v IRC*,[538] the court held that operation includes a company becoming non-resident. According to *Bambridge v IRC,*[539] it does not include death but extends to the act of making a will. In *Herdman v IRC*,[540] the court did not make a conclusive finding on whether the management of assets will also constitute an operation.

[536] Section 719 of the ITA 2007.
[537] Maston *Tolley's UK Taxation of Trusts 2018-19* para 23.4.
[538] 1948 30 TC 163.
[539] [1955] UKHL J1208-1.
[540] 45 TC 394

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Based on the above, in this context, an operation has a similar meaning to an event or an action. This means that the ambit is wide enough to cover all deliberate acts, but does not extend to any omissions. Neither does the definition include unavoidable natural occurrences nor routine tasks.

The phrase effected by any person serves as a qualification to the operation requirement.[541] This means that the operation can be effected by someone other than the transferor and still constitute an associated operation. Hence, it is not only limited to operations effected by the transferer.

Aside from the aforesaid, the definition introduces the last qualification to the operation requirement. For an operation to be classified as an associated operation, the operation must be in relation to the assets.[542] Unlike the first qualification, this qualification restricts the definition's reach. If this key phrase was not included, the definition would have otherwise been unworkable.

Before an operation can be an associated operation, it must be in relation to the assets transferred by the transfer.[543] This means that there must be a causal link between the operation in question and the specific assets that were transferred in the transfer under review. In other words, if the operation relates to assets that formed the subject of another transfer, one cannot conclude that said operation is an associated operation for purposes of the current transfer. However, it may be possible that the operation is an associated operation with regard to the previous transfer, but this will depend on the facts and circumstances of the case.

The definition further provides that it is irrelevant when the operation was effected.[544] If one interpreted this part of the provision literally, one would find that almost any operation is related to some or other transfer.

It is considered that a clean break test should be implied for the definition to make sense. This means that mere historical association is not enough to constitute associated operations for purposes of the transfer of assets provisions.[545]

[541] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.36.
[542] Section 719 subs (1) of the ITA 2007.
[543] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.21.
[544] Section 719 subs (2).
[545] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.21.

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Put differently, a transfer cannot be an associated operation in relation to a transfer if the transfers in question did not form part of a single arrangement and if the existence of the one transfer was unknown to the transferer of the other transfer.

In *Corbett's Executrices v IRC*,[546] the court confirmed the need for a clean break test. However, what constitutes a clean break must be determined by the facts of the case.

5 3 2 4 Relevant transfer

Throughout the transfer of assets regime, the key concept is relevant transfer. Only if the transfer in question meets all the requirements for a relevant transfer can the charging provisions apply.

The relevant section reads as follows:

> "(1) A transfer is a relevant transfer for the purposes of this Chapter if—
> (a) it is a transfer of assets, and
> (b) as a result of—
> (i) the transfer,
> (ii) one or more associated operations, or
> (iii) the transfer and one or more associated operations, income becomes payable to a person abroad." [547]

Based on the above definition, the following conditions must be satisfied for a transfer to constitute a relevant transfer:

1. There must be a transfer of assets.
2. Income must become payable to a person abroad.
3. There must be a causal link between the income that becomes payable to a person abroad and any one of the following:
   (i) the transfer; or
   (ii) associated operations; or
   (iii) both of the aforesaid.

[546] [1943] 2 All ER 218.
[547] Section 716 of the ITA 2007.

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If these criteria are met, the transfer will be a relevant transfer. However, the fact that there is a relevant transfer is not sufficient in itself to cause a tax charge.[548] (104) The further conditions in one of the charging sections must be satisfied.

A relevant transfer may be made for full consideration and need have no element of bounty or gratuitous intent.[549] However, this statement is qualified by the requirements that income must become payable to a person abroad as a result of the transfer, and the income must be identifiable.[550] Only if both these requirements are met, can one conclude that it is a relevant transfer.

Notwithstanding the aforementioned, before one can determine whether a transfer constitutes a relevant transfer, one must first ascertain what each of the conditions above actually mean. These conditions can be described as the prerequisites for any of the transfer of assets provisions to apply. To this extent, the above conditions will be discussed before the charging provisions are examined.

5 3 3 Transfer of assets

Before there can be a relevant transfer, there must be a transfer of assets.[551] For purposes of the transfer of assets regime, the term asset is defined as:

> "(a) "assets" includes property or rights of any kind, and
> (b) references to assets representing any assets, income or accumulations of income include references to—
> (i) shares in or obligations of any company to which the assets, income or accumulations are or have been transferred, or
> (ii) obligations of any other person to whom the assets, income or accumulations are or have been transferred."[552]

It is clear from this definition that the word "asset" is given its widest possible meaning. It includes all types of property, but more noteworthy, it extends to rights of any kind

[548] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.18.
[549] Para 25.18.
[550] Para 25.18.
[551] Section 716 subs (1)(a) of the ITA 2007.
[552] Section 717.

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as well. In other words, an obligation or future claim will also constitute an asset for purposes of the transfer of assets provisions.[553]

The word transfer is defined as "(2) In this Chapter "transfer", in relation to rights, includes the creation of the rights."[554]

This means a transfer is not only limited to an exchange of rights but extends to any arrangement where rights are created or conferred. Differently put, any transaction where one party obtains a right of some sort against the other party can potentially constitute a transfer.[555] Even unilateral arrangements that only create rights for one party are sufficient to be a transfer.

In *Brackett v Chater*[556] the court was confronted with a situation where an offshore company employed the taxpayer. The court held that a contract of employment creates rights between the parties, which means the employment relationship is an asset.[557] The act of entering into said contract, is enough to constitute a transfer. Hence, the court found that a transfer of assets did, in fact, occur.[558]

In most cases, a transaction will give rise to two simultaneous transfers. The first is the party that acquires the asset, and the other party gets the benefit of the consideration for the asset. However, there are exceptions to this construction. For one, gifts or donations will only give rise to a single transfer.

Despite what the name might suggest, there is no requirement that a UK-situated asset must become non-UK situated.[559] Similarly, the provisions equally apply to non-UK-situated assets that are transferred to another person abroad.[560] After all, the creation of rights may be a transfer of assets, and newly created assets are not situate anywhere before the transfer occurs.

[553] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 45.15.
[554] Section 716 subs (2) of the ITA 2007.
[555] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.18.
[556] [1986] STC 521.
[557] *Brackett v Chater* [1986] STC 521.
[558] *Brackett v Chater* [1986] STC 521.
[559] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.18.
[560] Para 25.18.

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5 3 3 1 Income payable to person abroad

The second requirement for a relevant transfer is that income must become payable to a person abroad.[561] In other words, income must become payable to a non-resident or foreign domiciled person.

In *IRC v Willoughby* ("*Willoughby*"),[562] the court concluded that this condition is satisfied where the transfer is to a UK resident and domiciled person who later becomes non-resident or foreign domiciled.

In *Latilla v IRC*,[563] the court held that the word payable has a wide meaning and should not be construed narrowly. The court found that the ambit is wide enough to extend to trading income.[564] In the income tax context, it is considered that the term payable does not have a more restricted meaning than arising, receiving or entitled. Instead of using a literal interpretation, one must rather follow a purposive construction.

In *Fynn v IRC,* the court found that if a person transfers funds to a person abroad, which then uses the transferred money to settle a debt, in principle, no income arises for the person abroad as a result of the transfer. This means that the transfer does not fulfil the requirements for a relevant transfer. However, such a transfer may still give rise to a tax charge in terms of section 727. Such a transfer will likely satisfy the requirements of a transfer connected with a relevant transaction.

If a non-resident or foreign domiciled person transfers assets to another person abroad, one may be tempted to conclude that there is no relevant transfer. This line of reasoning follows from the notion that both the transferor and the person who receives the transfer is outside the UK. Hence, if both parties are already outside the UK, no income becomes payable to a person abroad. Although linguistically speaking, such an argument may seem possible, the context shows that such an interpretation is wrong.

In the case that a UK resident person acquires an asset from a person abroad for a cash consideration, at first glance, the payment of the purchase price appears to be a relevant transfer. Since the payment is a transfer of assets, as a result of the

[561] ITA 2007 section 716 subs (1)(b).
[562] [1997] STC 995 (HL).
[563] [1943] AC 377.
[564] *Latilla v IRC* [1997] STC 995 (H.L.).

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payment, income will normally arise to the person abroad. However, it is considered that this is not the case if the following applies:[565]

1. if it was not for the sale, the asset would still have yielded income to the person abroad; and
2. the purchase price does not exceed the market. Value of the asset.

In the above-mentioned circumstances, the person abroad obtains the income arising from the purchase price, but loses the income arising from the asset. Broadly speaking, if the two income streams cancel each other out, it cannot be said that any income becomes payable to the person abroad.

The same will apply if the roles are reversed if, instead, the UK resident person sells an asset to a person abroad for a cash consideration.

If this line of reasoning is accepted, the transfer of asset provisions will not apply each time a UK resident buys or sells an asset to or from a non-resident person. Conversely, if this is not the case, it would be bazaar if a person's only option to stop the provision from applying is to invoke one of the exceptions to the provisions.

However, the position would be different if the purchase price was not a consideration of cash, but rather paid in some other form.[566] For example, the issue of shares or debentures or a life policy.

Even if it has been ascertained that income becomes payable to a person abroad, it will only classify as a relevant transfer if the income that arises to the person abroad is identifiable.[567]

Aside from the aforesaid, it can only be a relevant transfer if income becomes payable to a person abroad.[568] Hence, the question is what constitutes income for the transfer of assets provisions.

In the context of the transfer of asset rules, the income referred to means income for income tax purposes.[569] This is a different concept from "income for trust law purposes" or "income for accounting purposes".

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[565] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 45.15.
[566] Para 45.15.
[567] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.18.
[568] section 716 subs (1)(b) of the ITA 2007.
[569] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.18.

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In considering whether any item is income, it is relevant to consider its character in the hands of the person who actually receives it.[570] Unless there is a specific provision that identifies a particular item as income for all UK tax purposes or specifically for the purpose of the transfer of assets legislation. This means in the absence of a provision determining that an item is income, the amount received by the person must be treated as income for this condition to be satisfied.

5 3 3 1 1 Causal link

In light of the above discussions, if one has determined that a transfer of assets has occurred[571] and that income became payable to a person abroad,[572] one might be quick to conclude that the arrangement is a relevant transfer. However, the fact that the above requirements are met, is not on its own enough to constitute a relevant transfer.

Aside from the above requirements, there must also be a causal connection between the income that became payable to the person abroad and the transfer or an associated operation or both.[573] This means that the income cannot be payable by accident or some other reason unrelated to the arrangement.

In order to ascertain whether there is a causal relationship, one can use the but for test. But for the transfer, did the income become payable?[574] If the answer is no, one must continue to the second option. But for an associated operation, did the income become payable?[575] Only if one or both of the above questions is answered in the affirmative can one say that it is a relevant transfer.

5 3 3 2 Charge on income

Section 720 is the first of three charging provisions of the transfer of assets regime.[576] It imposes a tax charge on the transferer on all income that is treated as arising to the transferer under section 721.[577]

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[570] Para 25.18.
[571] Section 716 subs (1)(a) of the ITA 2007.
[572] Section 716 subs (1)(b).
[573] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 45.15.
[574] Section 716 subs (1)(b)(i) of the ITA 2007.
[575] Section 716 subs (1)(b)(ii).
[576] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.11.
[577] Section 720 of the ITA 2007.

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The provision targets the situation where UK resident individual taxpayers transfer assets to a non-resident, which results in income becoming payable to the person abroad, in order to avoid or to minimise their UK income tax liability.[578] If such an arrangement is successful, it means that the income from the asset is no longer received in the taxpayer's hands, but rather accrues to the non-resident.

The relevant section reads as follows:

> "(1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are UK resident by means of relevant transfers.
>
> (2) Income tax is charged on income treated as arising to such an individual under section 721 (individuals with power to enjoy income as a result of relevant transactions).
>
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year
>
> …
>
> (5) The person liable for any tax charged under this section is the individual to whom the income is treated as arising."[579]

If section 720 applies to an arrangement, the provision assigns the liability to tax to the person to whom the income is treated as arising.[580] However, to determine who the person is, the provision refers to section 721.[581] If one turns to section 721, one finds a referential definition.

The relevant section reads as follows:

> "(1) Income is treated as arising to such an individual as is mentioned in section 720(1) in a tax year for income tax purposes if conditions A to C are met." [582]

In light of the above, one can derive that the provision is only applicable to natural persons. Aside from the aforesaid, it is evident that the definition does not contribute

[578] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.13.
[579] Section 720 of the ITA 2007.
[580] Section 720 subs (5) of the ITA 2007.
[581] Section 720 subs (2).
[582] Section 721.

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much to ascertaining the meaning of individual. Instead of providing a clear definition of the term used, the provision merely refers back to section 720(1).[583] The only hint to what individual means in this context is the words “such an individual”.

According to *Vestey v IRC*,[584] such an individual is the person who transfers assets abroad, who, by means of such transfers, avoid a tax liability, and who manages to obtain or to be in a position to obtain, benefits from those assets while remaining resident in the UK.

Based on the above, one can derive the following requirements for a person to constitute such an individual. The individual concerned must:

1. be resident in the UK; and
2. be the transferor; and
3. avoid a liability to UK income tax.

The requirements for determining one’s residency status have already been discussed in prior sections.[585] Nevertheless, the more pertinent question is, who is the transferer?

As a point of departure, anyone that actually makes a transfer is a transferer.[586] However, the term has a wider meaning. Under certain circumstances, the term can extend beyond the person who actually made the transfer.

In *Congreve v IRC*,[587] the court held that an individual that procures a transfer could also satisfy the requirement that said individual must be the transferer. Even though the individual concerned did not actually execute the transfer.[588] However, this will depend on the facts and circumstances of the case.

According to HMRC, the term transferer is not only limited to the individual that made the actual transfer but can also extend to an individual that was associated with the transfer.[589] However, the accuracy of this interpretation is doubtful.

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583 Section 720 subs (1).
584 [1980] STC 10.
585 See Chapter 4 paragraph 4 3 2.
586 Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.11.
587 (1948) 30 TC 163.
588 *Congreve v IRC* (1948) 30 TC 163.
589 HM Revenue & Customs “INTM600020 – Transfer of Assets Abroad: Overview of ITA2007/Sections 721 and 727 (Income Charge)” (07-01-2023) <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm600020> (accessed 10-03-2022).

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In *IRC v Pratt,*[590] the court decided that an individual that is associated with a transfer or has a hand in a transfer is not in any way equivalent to making the transfer. This means that a person who is merely associated with a transfer is not enough to constitute a transferer.

In *Fisher v HMRC,*[591] the court found that it is possible that there can be multiple transferors. In such a case, it is appropriate to apportion the income among the transferors.

The provision will not apply if a trustee transfers assets to a non-resident.[592]

This can be explained by the following reasons:

1. A trustee is not an individual, which means trustees fall outside the transfer of assets regime.
2. A trustee is not a transferor, since a transferor must be the person beneficially entitled to the assets transferred.

If the trustees are not covered by the provision, it raises the question, what about other parties to the trust? In the case of a settlor, it will depend on the powers afforded to the settlor under the trust. Although, if the settlor's powers are of such nature that the settlor can facilitate a transfer, the trust will be regarded as settlor interested. In such a case, section 624 will apply.[593]

Concerning the beneficiaries, if one considers that beneficiaries do not have the power to transfer trust assets, the only option is to regard the beneficiaries as having procured the transfer by the trustees. However, before one can conclude that an individual procured the transfer, the individual must be in control of the person making the actual transfer. Hence, even if beneficiaries of a trust direct the trustees to make a transfer, such an arrangement will still fall foul of the requirements.

Aside from the first two requirements, such an individual must avoid liability to UK income tax.[594] It is considered that an intention to avoid income tax is not required, but the requirement rather revolves around the question of whether income tax has, in fact, been avoided.

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[590] [1982] STC 756.
[591] [2021] EWCA Civ 1438.
[592] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.11.
[593] Section 624 of the ITA 2007.
[594] Section 720 subs (1).

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In other words, the key question is whether the outcome of the transactions is of such nature that the individual would have avoided a liability to income tax if it was not for the operation of the charging provision.

It follows that the transferer's subjective intention for transferring the assets is irrelevant.[595] Instead, an objective examination of the facts is necessary.

After the above determination, section 721 further provides three conditions that must be satisfied before the income can be treated as that of the individual and accordingly be assessed in said person's hands.

The relevant section reads as follows:

> "(2) Condition A is that the individual has power in the tax year to enjoy income of a person abroad as a result of—
> (a) a relevant transfer,
> (b) one or more associated operations, or
> (c) a relevant transfer and one or more associated operations.
> (3) Condition B is that the income of the person abroad would be chargeable to income tax if it were the individual's and received by the individual in the United Kingdom.
> (3A) Condition C is that the individual is UK resident for the tax year."[596]

Before a liability to tax can be imposed on the individual for the income that is deemed to be received by said individual, the first condition is that there must be a power to enjoy the income that arises to the person abroad.[597] The power to enjoy must be as a consequence of the relevant transfer, an associated operation or both.[598]

As one encountered with other terms used throughout the transfer of assets regime, section 722 contains a circular definition of the term power to enjoy.[599] To ascertain the meaning of the aforesaid, one is referred to section 723, which outlines five scenarios that will constitute power to enjoy.

The relevant section reads as follows:

[595] Maston *Tolley's UK Taxation of Trusts 2018-19* para 7.2.
[596] Section 721 of the ITA 2007.
[597] Section 721 subs (2).
[598] Section 721 subs (2).
[599] Section 722.

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"(1) For the purposes of section 721, an individual is treated as having power to enjoy income of a person abroad if any of the enjoyment conditions are met.

(2) In subsection (1) 'the enjoyment conditions' means conditions A to E as specified in section 723.

(3) In determining whether an individual has power to enjoy income for the purposes of section 721, regard must be had to the substantial result and effect of all the relevant transactions.

(4) In making that determination all benefits which may at any time accrue to the individual as a result of the transfer and any associated operations must be taken into account, irrespective of—

(a) the nature or form of the benefits, or

(b) whether the individual has legal or equitable rights in respect of the benefits."[600]

For purposes of determining whether the individual has the power to enjoy the income, one must consider the substance over the form of the transactions.[601] This simply means one must adopt a holistic approach and not look at each transaction in isolation. The provision further reiterates that one should not construe this section narrowly.[602]

If one turns to section 723, one encounters a comprehensive definition of power to enjoy. The provision uses five distinct scenarios to describe the ambit of the term.[603] If any one of these five criteria is satisfied, one can conclude that power to enjoy the income is present.

Although the term power to enjoy is elaborately defined to cover all possible circumstances, it was nevertheless the subject of numerous court cases. Notwithstanding the aforesaid, it is considered that, in practice, it does not pose much of a problem.

The relevant section reads as follows:

"(1) Condition A is that the income is in fact so dealt with by any person as to be calculated at some time to enure for the benefit of the individual, whether in the form of income or not.

600 Section 722.
601 Section 722 subs (4)(a).
602 Section 722 subs (3).
603 Section 723.

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(2) Condition B is that the receipt or accrual of the income operates to increase the value to the individual—

(a) of any assets the individual holds, or

(b) of any assets held for the individual's benefit.

(3) Condition C is that the individual receives or is entitled to receive at any time any benefit provided or to be provided out of the income or related money.

(4) In subsection (3) "related money" means money which is or will be available for the purpose of providing the benefit as a result of the effect or successive effects

(a) on the income, and

(b) on any assets which directly or indirectly represent the income, of the associated operations referred to in section 721(2).

(5) Condition D is that the individual may become entitled to the beneficial enjoyment of the income if one or more powers are exercised or successively exercised.

(6) For the purposes of subsection (5) it does not matter—

(a) who may exercise the powers, or

(b) whether they are exercisable with or without the consent of another person.

(7) Condition E is that the individual is able in any manner to control directly or indirectly the application of the income." [604]

In broad terms, the test to determine whether a power to enjoy exists is very similar to that used in section 624.[605] However, it is considered that the former is slightly wider.

Based on the above, one can derive that a power of enjoyment will be present if the individual or the individual's spouse is able to obtain any benefit from the income arising to the person abroad, or may possibly benefit in future, or can benefit by virtue of certain rights. It follows that there is no prerequisite that actual enjoyment must take place, but rather the mere ability to enjoy the income is enough to establish a power to enjoy. Put differently, one should be cognisant of all the potential benefits that may accrue to the individual as a result of the relevant transactions, regardless of the form of the benefits or whether any right exists to those benefits.

Conversely, there will be no power to enjoy if the individual and the individual's spouse are excluded from benefiting and have no power of control over the income.

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[604] Section 723.

[605] Section 624 of the Income Tax (Trading and Other Income) Act 2005.

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However, it is not sufficient for a power to enjoy simply to exist, power to enjoy must be as a result of a relevant transfer, an associated operation or both.[606] Only if the causal link is present can one conclude that all the requirements for the first condition are complied with.

Before the section 720 income charge can apply, the second condition is that the income of the person abroad must be subject to income tax if the income in question was received by the UK resident individual.[607]

It is considered that this requirement is redundant since, in practice, this condition will always be met. In other words, it is difficult to think of a case where the income of the person abroad would not be chargeable to income tax if received by a UK resident in the UK.

The third and final condition is that the individual must be a UK resident for the year of assessment.[608] This means that section 720 does not apply to income which arises in a year when the individual is not resident in the UK. However, it is irrelevant whether or not the individual was resident in the UK in the year that the transfer took place.[609]

If the individual later becomes a UK resident, the individual does not incur a retrospective liability under section 720 for income accruing while non-resident. This is consistent with the usual income tax position.

Section 721 further provides rules to calculate the amount of income that arises to the person abroad that must be attributed to the individual for tax purposes.

The relevant section reads as follows:

"(3B) The amount of the income treated as arising under subsection (1) is (subject to sections 724 and 725) given by the following rules—

Rule 1 The amount is equal to the amount of the income of the person abroad if the individual—

(a) is domiciled in the United Kingdom at any time in the tax year, or

(b) is at any time in the tax year regarded for the purposes of section 718(1)(b) as domiciled in the United Kingdom as a result of section 835BA having effect because of Condition A in that section being met.

[606] Section 721 subs (2) of the ITA 2007.
[607] Section 721 subs (3).
[608] Section 721 subs (3A).
[609] Section 721 subs (5)(b).

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Rule 2 In any other case, the amount is equal to so much of the income of the person abroad as is not protected foreign-source income (see section 721A).

(3BA) In a case in which rule 2 of subsection (3B) applies, so much of the income of the person abroad as is protected foreign-source income for the purposes of that rule counts as "protected income" for the purposes of section 733A(1)(b)(i).]

(3C) Subsection (1) does not apply if—

(a) the individual is liable for income tax charged on the income of the person abroad by virtue of a charge not contained in this Chapter, and

(b) all that income tax has been paid.]

(4) For the purposes of subsection (2), it does not matter whether the income of the person abroad] may be enjoyed immediately or only later.

(5) It does not matter for the purposes of this section—

(a) . . .

(b) whether the individual is UK resident for the tax year in which the relevant transfer is made (if different from the tax year mentioned in subsection (1)), or]

(c) whether the avoiding of liability to income tax is a purpose for which the transfer is effected."[610]

The section 720 income charge is not limited to the income that the individual is actually entitled, or able, to receive, but extends to all income.[611] In other words, if the individual has power to enjoy over all the income of a non-resident, the individual will be subject to tax on all the income, even though the individual's power to enjoy is limited to an unidentifiable part or even none of the income.

However, if the individual has the power to enjoy over only part of the income, the individual is only taxed on the income that the individual has the power to enjoy.

As alluded to previously, the provision does not extend to income that was already subjected to tax by virtue of another section of the income tax legislation.[612] In addition, protected foreign source income is also excluded from the quantum of income that is subject to tax.[613]

[610] Section 721.
[611] Section 721 subs (1).
[612] Section 721 subs (3C)(a).
[613] Section 721 subs (3BA).

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5 3 3 3 Charge on capital sum

Section 727 is the second of three charging provisions of the transfer of assets regime. It levies a tax charge on the transferer on all income that is treated as arising to the transferer under section 728.[614] The provision operates independently from section 720.

The provision is aimed at the situation where UK resident individual taxpayers transfer assets to a non-resident in order to avoid or to minimise their UK tax liability but carefully structures the arrangement in such a way that no power of enjoyment is afforded to the UK resident transferor.[615] In other words, section 727 is intended to cover the gap in cases where taxpayers succeed in circumventing the income tax charge under section 720 while still receiving income from the foreign entity. If such an arrangement is successful, the result is not only that the income becomes payable to the person abroad, but the arrangement also avoids the application of the anti-avoidance provision.

The relevant section reads as follows:

> "(1) The charge under this section applies for the purpose of preventing the avoiding of liability to income tax by individuals who are UK resident by means of relevant transfers.
>
> (2) Income tax is charged on income treated as arising to such an individual under section 728 (individuals receiving capital sums as a result of relevant transactions).
>
> (3) Tax is charged under this section on the amount of income treated as arising in the tax year."
>
> (4) The person liable for any tax charged under this section is the individual to whom the income is treated as arising."[616]

At first glance, one can notice that there is a striking resemblance to the charge on income provision. Section 727 is basically identical to that of section 720, with the exception of the wording used in subsection (2) and some minor differences in the

614 Section 727.

615 Maston *Tolley's UK Taxation of Trusts 2018-19* para 7.17.

616 Section 727 of the ITA 2007.

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numbering of certain subsections. While section 720(2) is aimed at individuals with the power to enjoy,[617] section 727(2) focuses on individuals receiving capital sums.[618]

By virtue of the provision, it imposes a tax charge on the person to whom the income is treated as arising.[619] As with section 720, the term individual is not defined, instead the provision refers to section 728.[620] If one consults section 728, one encounters the same referential definition as is used in section 721.

The relevant section reads as follows:

> "(1) Income is treated as arising to such an individual as is referred to in section 727(1) in a tax year for income tax purposes if—
>
> (a) income has become the income of a person abroad as a result of—
>
> (i) a relevant transfer,
>
> (ii) one or more associated operations, or
>
> (iii) a relevant transfer and one or more associated operations,
>
> (b) the capital receipt conditions are met in respect of the individual in the tax year (see section 729), and
>
> (c) the individual is UK resident for the tax year]."[621]

Based on the above, it is evident that section 727 has adopted the same definition of individual as section 720.[622] By extension, the requirements are also identical. For this reason, the discussion on the requirements for constituting such an individual will not be reproduced.

In addition to the aforesaid, the provision contains three conditions that need to be satisfied before the tax charge can be levied upon the individual. The first requirement is that income must have become the income of a person abroad as a consequence of a relevant transfer, an associated operation or both of the aforementioned.[623] In other words, there must first be a causal link between the income that became payable to the non-resident and the relevant transactions.

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[617] Section 720 subs (2).
[618] Section 727 subs (2).
[619] Section 727 subs (4).
[620] Section 727 subs (2).
[621] Section 728.
[622] Section 720.
[623] Section 728 subs (1)(a)

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Section 727 does not deem the capital sum to be income; instead, it takes income which has become payable to persons abroad as a result of the transfer and deems that income to be that of the individual.[624]

In *Vestey v IRC*,[625] the court held that it is any income of the foreign transferees which is deemed to be the income of the recipient of a capital sum. The court further explained that the operation of the provision is not affected by the value of the capital sum received.[626] Finally, the provision applies regardless of when the distribution is made.

Aside from the above, the second requirement is that the capital receipt conditions must be met in respect of the individual in question.[627] To this extent, one is referred to section 729, which outlines under which circumstances a capital sum will constitute a capital receipt.

The relevant section reads as follows:

"(1) For the purposes of section 728(1), the capital receipt conditions are met in respect of the individual in a tax year ("the relevant year") if—
- (a) either—
  - (i) in the relevant year the individual receives or is entitled to receive any capital sum, whether before or after the relevant transfer, or
  - (ii) in any earlier tax year the individual has received any capital sum, whether before or after the relevant transfer, and
- (b) the payment of that sum is (or, in the case of an entitlement, would be) in any way connected with any relevant transaction.

(2) But subsection (1)(a)(ii) does not apply merely because of the receipt of a sum by way of loan if the loan is wholly repaid before the relevant year begins.

(3) In subsection (1) "capital sum" means—
- (a) any sum paid or payable by way of loan or repayment of a loan, and
- (b) any other sum paid or payable—
  - (i) otherwise than as income, and
  - (ii) not for full consideration in money or money's worth.

[624] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 35.14.
[625] [1980] STC 10.
[626] *Vestey v IRC* [1980] STC 10.
[627] Section 728 subs (1)(b) of the ITA 2007.

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(4) For the purposes of subsection (1), a sum is treated as a capital sum which the individual ("A") receives or is entitled to receive if another person receives or is entitled to receive it—

(a) at A's direction, or

(b) as a result of the assignment by A of A's right to receive it."[628]

For a capital sum to qualify as a capital receipt, the individual must receive or be entitled to receive a capital sum in that year of assessment.[629] Alternatively, the condition will also be satisfied in the year in question if the individual received a capital sum in any prior year of assessment.[630]

Conversely, the condition will not be fulfilled if the individual was entitled to receive a capital sum in an earlier year, but the entitlement has ceased, and the individual did not actually receive any income.[631]

This means if any one of the above scenarios is applicable, the criteria under subsection (1)(a) of section 729 will be complied with. However, the capital receipt determination is still subject to part (b) of subsection (1).

Section 729(1)(b) further requires that the capital sum must be in any way connected with any relevant transaction.[632] Differently put, only capital sums that are made from income that arose by virtue of a relevant transaction will qualify as a capital receipt. If the income used to make the payment is unrelated to the transfer and associated operations, it will fall outside the scope of section 727.

The definition of capital sum is the only place where the expression "connected with" is used in the transfer of assets provisions.[633] However, it is suggested that the words have the same meaning as the phrase "in relation to", which is used in the definition of associated operations.[634]

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[628] Section 729.
[629] Section 729 subs (1)(a)(i).
[630] Section 729 subs (1)(a)(ii).
[631] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 35.14.
[632] Section 729 subs (1)(b) of the ITA 2007.
[633] Section 729 subs (3).
[634] Section 719.

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For purposes of this provision, section 729(3) adopts an artificial definition of the term capital sum.[635] It is the same definition used in section 634.[636] By extension, the definition extends to the same circumstances as the latter.

If a person abroad lends to a UK resident individual, the receipt of the loan amount constitutes a capital sum.[637] Similarly, if a UK resident individual provides a loan to a non-resident, the repayment of such loan will be regarded as a capital sum in the resident individual's hands.[638] Due to the far-reaching consequences of the provision, it is considered that in this context, loan should be interpreted narrowly.

Therefore, if a UK resident individual sells an asset at market value to a non-resident person, the payment of the purchase price is not a capital sum.[639] This follows from the notion that such a transaction is not a loan and that full consideration is received for the asset in question. However, if the price is inflated, it may constitute a capital sum.

In *Ramsden v CIR,*[640] the court held that a sale of an asset to a non-resident person for full consideration will not be regarded as a capital sum, even if the UK resident individual leaves the cost of the assets credited to his account. However, the presence of an account with a person abroad to which sums are credited may be indicative of that individual having the power to enjoy the income abroad.

Similarly, in *Lee v CIR,*[641] the court found that if promissory notes or debentures payable on demand are issued to the individual as part of the consideration for the transfer of assets, such amounts payable under the notes will not be treated as a capital sum for this purpose. This stems from the fact that the amounts payable under the notes are not regarded as a loan, but it is for full consideration. However, such an issue of promissory notes may give rise to a power to enjoy the income of the person abroad and bring the individual within the ambit of that income charge.[642]

Section 729(4) serves to extend the ambit of the capital charge by assigning a synthetic meaning to the words receives or entitled to receive.[643] It is considered that

[635] Section 729 subs (3).
[636] Income Tax (Trading and Other Income) Act 2005 section 634.
[637] Section 729 subs (3)(a) of the ITA 2007.
[638] Section 729 subs (3)(a).
[639] Section 729 subs (3)(b).
[640] (1957) 37 TC 619 D3.402.
[641] [1962] HCA 35.
[642] Section 720 of the ITA 2007.
[643] Section 729 subs (4).

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a person is not entitled to receive a sum until it is due and payable.[644] Hence, if an individual lends to a person abroad, on such terms that the loan is repayable on a fixed date, the capital receipt condition is not met before that date. However, if the debt is repayable on demand, the individual is entitled to receive said payment even if they have not formally issued a demand for payment.

This means that the provision is not limited to capital sums that are earmarked for the individual taxpayer but will also be applicable if the individual can direct income to someone else or if the individual can assign the right to income that would otherwise have been payable to the individual to another person of his choice.

Due to the way in which the provision is drafted, It is possible that at one time the capital receipt conditions are not satisfied, and later they become satisfied. Notwithstanding the aforesaid, the operation of section 727 cannot apply retrospectively. In *Vestey v IRC*,[645] the court found that the provision does not provide that the income of the non-resident in any year before the person receives or is entitled to receive is to be deemed to be that person's income. Instead, the working of the provision can only be invoked once the individual has received or is entitled to receive the income from the person abroad.[646]

The section 727 charge applies to income arising in the year in which the capital receipt condition is met. However, once that condition is met in one year, it is generally met in all future years of assessment. Thus, section 727, in principle, applies to the income of the person abroad in the year that the capital receipt condition is first met but will also apply in all subsequent years of assessments.

Following from the former, the provision provides two narrow exceptions to this rule. It is considered that no liability will ensue to the individual if any of the below scenarios are applicable:[647]

1. a loan to the individual which the individual has repaid; or
2. a loan to the person abroad, which the individual later waives.

[644] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.44.
[645] [1980] STC 10.
[646] *Vestey v IRC* [1980] STC 10.
[647] Section 729 subs (2) of the ITA 2007.

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Aside from the above, the liability can only follow if the third and final condition is met. The last requirement is that the individual must be a UK resident in the tax year.[648] Therefore, the tax charge is limited to resident individuals and cannot extend to capital sums that arise during those years that the individual has ceased to be a UK resident.

In the proceeding subsections, section 728 further adopts the same formula as is used in section 721 for determining the quantum of income that is subject to the tax charge.[649] To this extent, taxpayers are afforded the benefit of the same limitations and safeguards. In addition, the section also mirrors the disclosures and general provisos. For this reason, no further discussion is necessary.

The relevant section reads as follows:

> "(1A) The amount of the income treated as arising under subsection (1) is (subject to subsection (2)) given by the following rules—
>
> Rule 1 The amount is equal to the amount of the income of the person abroad if the individual—
>
> (a) is domiciled in the United Kingdom at any time in the tax year, or
>
> (b) is at any time in the tax year regarded for the purposes of section 718(1)(b) as domiciled in the United Kingdom as a result of section 835BA having effect because of Condition A in that section being met.
>
> Rule 2 In any other case, the amount is equal to so much of the income of the person abroad as is not protected foreign-source income (see section 729A)
>
> (1B) In a case in which rule 2 of subsection (1A) applies, so much of the income of the person abroad as is protected foreign-source income for the purposes of that rule counts as "protected income" for the purposes of section 733A(1)(b)(i).
>
> (2) Section 725 (reduction in amount charged where controlled foreign company involved) applies for determining the amount of income treated as arising under subsection (1 as if—
>
> (a) in subsection (1) of that section—
>
> (i) the reference to section 721 were a reference to this section, and
>
> (ii) the reference to section 721(2) were a reference to subsection
>
> (1) (a) of this section, and
>
> (b) subsections (2A) and (2B) of that section were omitted.]
>
> (2A) Subsection (1) does not apply if—

[648] Section 728 subs (1)(c).
[649] Section 721.

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(a) the individual is liable for income tax charged on the income of the person abroad by virtue of a charge not contained in this Chapter, and

(b) all that income tax has been paid.]

(3) It does not matter for the purposes of this section—

(a) …

(b) whether the individual is UK resident for the tax year in which the relevant transfer abroad is made (if different from the tax year mentioned in subsection (1)), or]

(c) whether the avoiding of liability to income tax is a purpose for which that transfer is effected."[650]

5 3 3 4 Charge on benefit

Section 731 is the third and final substantive charging provision under the transfer of assets regime. The provision imposes a tax charge on the beneficiary on the value of the benefits received from the person abroad.[651] For purposes of this provision, section 732 quantifies the benefits and treats said amount as the beneficiary's income.[652] The charge operates concurrently with section 720 and section 727, but does not apply accumulatively to income that is already subject to income tax.[653]

The provision focuses on arrangements that is specifically crafted to fall outside the ambit of the other charging provisions but is nevertheless in line with the anti-avoidance objective. The provision predominantly applies to individuals, which are not regarded as transferors, but still receive a benefit from a non-resident person as a result of a relevant transfer.[654] However, the charge can also apply to a transferer.

Section 731 typically targets those situations where UK resident individual taxpayers transfer assets to a non-resident for tax considerations but is structured to provide a benefit to a certain party. In the absence of this provision, such arrangements will succeed in eroding the UK tax base, while UK residents are still able to benefit from the assets transferred offshore without any tax implications.

The relevant section reads as follows:

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[650] Section 727.
[651] Section 731.
[652] Section 732.
[653] Maston *Tolley's UK Taxation of Trusts 2018-19* para 36.1.
[654] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 35.14.

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> "(1) Income tax is charged on income treated as arising to an individual under section 732 (individuals receiving a benefit as a result of relevant transactions)."
>
> (2) Tax is charged under this section on the amount of income treated as arising for the tax year.
>
> (3) The person liable for any tax charged under this section is the individual to whom the income is treated as arising, but this is subject to section 733A."[655]

The operation of the provision imposes a tax charge on the person to whom the income is treated as arising.[656] In order to ascertain whether the individual has received a benefit, the provision refers to section 732.

Section 732 outlines five conditions that need to be satisfied before one can conclude that an individual has received a benefit as a result of a relevant transaction.[657]Only if the aforesaid is answered in the positive can the section 731 charge apply to the individual concerned.

The relevant section reads as follows:

> "(1) This section applies if—
>
> (a) a relevant transfer occurs,
>
> (b) an individual receives a benefit in a tax year,
>
> (c) the benefit is provided out of assets which are available for the purpose as a result of—
>
> (i) the transfer, or
>
> (ii) one or more associated operations,
>
> (d) where there is a time in the year when the individual is relevantly domiciled, the individual is not liable to income tax under section 720 or 727 by reference to the transfer, and
>
> (c) the individual is not liable to income tax, under any provision that is none of section 731 of this Act and sections 643A, 643J and 643L of ITTOIA 2005, on the amount or value of the benefit." [658]

[655] Section 731 of the ITA 2007.
[656] Section 731 subs (3).
[657] Section 732.
[658] Section 732.

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Before the section 731 charge can be invoked, the first condition is that there must be a relevant transfer.[659] Despite the present tense used in the provision, it is considered that this condition is met in a year if a relevant transfer occurred in an earlier year.

The second application condition requires that the individual receives a benefit.[660] This is where the complexity of the section comes to the forefront. The intricacy of the section does not stem from the novelty of the term used. On the contrary, the word benefit is used throughout tax statutes.[661] Instead, the difficulty pertains to the meaning that should be assigned to the term and the demarcation of the ambit.

The determination can be divided into two aspects. First, there is the question of whether a benefit has been received for the purposes of the provision. Second, one must identify who is the recipient of said benefit.[662] Ultimately, it is the individual who receives the benefit that is the one who is taxable. To a large extent, these questions are interlinked. Although there are many possible permutations and circumstances, the fundamental principles remain the same.

As a point of departure, the term "benefit" is not defined in any of the transfer of assets provisions. However, it is clear that the word benefit is a word of wide import. The exact meaning has been the subject of many court cases.

Depending on the context, the word benefit can be used with two distinct meanings, a strict or narrow meaning and a loose or wide or meaning.[663] In the strict sense of the word, benefit refers to benefits that can be objectively valued. In other words, it can be quantified in financial terms. Conversely, the wider meaning includes non-financial advantages, of which the value is subjective or not readily ascertainable. Such benefits may be described as indirect or intangible.

In *Children's Investment Fund Foundation v AG*,[664] the court stated that in interpreting the word benefit, one must consider the spirit of the provision. However, ultimately the context will determine which meaning of benefit is applicable.

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[659] Section 732 subs (1)(a).
[660] Section 732 subs (1)(b)
[661] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.2.
[662] Para 36.2.
[663] Maston *Tolley's UK Taxation of Trusts 2018-19* para 36.1.
[664] [2017] EWHC 1379.

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According to *Burton v HMRC*,[665] the tax code requires the benefit received or treated as received to be identifiable and quantifiable if there is to be sufficient certainty to impose a tax charge for any particular year of assessment.

This means that if a beneficiary receives a non-financial benefit that provides the beneficiary with mental satisfaction or discharges a moral obligation or desire will not constitute a taxable benefit. This is equally the case if the benefit derived is merely incidental.

In *IRC v Lactagol*,[666] the court found that an arm's length transaction is not regarded as a benefit. In other words, if full consideration is tendered in the arrangement or if neither party has a gratuitous intent. This is the case even if the parties are regarded as connected persons.

However, context may show that the word benefit also includes the benefit of taking something for which one has given full consideration. Although it is linguistically correct to speak of a borrower receiving the benefit of a loan, it is considered that if the loan is on commercial terms there is no benefit for tax purposes.[667] Only if the loan is provided on favourable terms or if the outstanding liability is subsequently waived will it give rise to a chargeable benefit. In such a case, the value of the benefit is not the face value of the debt waived, but the market value.

Conferring an interest to a beneficiary under a settlement is not a benefit.[668] If the interest is conditional, the current value is nil. If it is an irrevocable benefit, it can be regarded as a benefit in the wide sense, but not for purposes of the charge under section 731. In such a case, it can more accurately be described as a right to a future benefit. Only when the interest materialise, can there be a taxable benefit. At that stage, the value of the benefit is the market value of the asset received.

If it has been ascertained that there exists a benefit, and the recipient of said benefit has been identified, one must quantify the value of the benefit received.

In *Heaton v Bell,*[669] the court described the notion of value as:

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[665] [2009] UKFTT 320 (TC).
[666] [2004] STC 315.
[667] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.2.
[668] Para 36.2.
[669] [1969] 46 TC 211.

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> "Value is an elusive word: it may mean market value, it may mean value in money to the owner, or it may have other meanings like the value of the work necessary to produce it, or even sentimental value."

In *IRC v Botnar*,[670] the court held:

> "It seems to us that the whole of the value of a non-convertible benefit should, in the absence of any other objective means of valuation, be measured by reference to what it would have cost the individual receiving it ... . When measuring what benefit an individual receives it is not in our view relevant to ask whether he would have purchased the benefit himself. If that were the test a penurious individual receiving a non-money benefit under [enjoyment condition C] would escape tax however substantial the benefit since he could not have paid for it."

If the benefit received is money, generally speaking, the amount or value of the benefit is equal to the amount received.[671] Where the benefit received is in the form of an asset other than cash, and the ownership of that asset actually passes to the individual, as opposed to an asset being made available for use which remains in the ownership of the provider, the amount or value of the benefit is likely to be determined by reference to the value of the asset at the point in time when it is received by the individual taxpayer.[672]

If the benefit pertains to the right of enjoyment of an asset, or the settling of a liability, the value of the benefit will be the equivalent cash amount of what it would have cost the individual to be in the same position if it was not for the benefit provided.[673] However, If the individual receiving a benefit makes any contribution towards that benefit, the contribution will normally be taken into account in determining the amount or value of the benefit.

In an attempt to simplify the valuation of benefits for tax purposes, the legislator has introduced a range of statutory valuation rules.

The relevant section reads as follows:

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670 [1998] STC 38.
671 Maston *Tolley's UK Taxation of Trusts 2018-19* para 36.1.
672 Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.2.
673 Para 36.2.

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> "Sections 742C to 742E apply where it is necessary, for the purpose of calculating a charge to income tax under the preceding provisions of this Chapter, to determine the value of a benefit provided to a person by way of—
>
> (a) a payment by way of loan (see section 742C),
>
> (b) making available movable property without any transfer of the property in it (see section 742D), or
>
> (c) making available land for use without transferring the whole interest in it (see section 742E)." [674]

The statutory valuation rules are applicable to determine the value of a benefit, if the benefit provided is by way of loan or the use of property. It has been suggested that where a loan is provided for full consideration, there is no benefit, and the statutory valuation rules do not apply.

However, the word benefit can be used to refer to a loan on commercial terms, even though the taxable value in such a case will be nil. In the context of the statutory valuation rules, it is considered that this is the better view. This means that a loan on commercial terms is within the statutory valuation rules, and the same applies to the use of other property.[675]

For benefits that do not fall within one of the above-mentioned categories, the value is determined by the market value of said benefit. In such a case, the principles outlined by the court will be applicable in the determination.

As previously alluded to, a beneficial loan will constitute a benefit for tax purposes. A beneficial loan can either take the form of an interest-free loan, a low-interest loan or a loan that is on more favourable terms than what can be obtained in the open market.[676]

The relevant section reads as follows:

> "(1) The value of the benefit provided to a person (P) by a payment by way of loan to P is, for each tax year in which the loan is outstanding, the amount (if any) by which—
>
> (a) the amount of interest that would have been payable in that year on the loan if interest had been payable on the loan at the official rate, exceeds
>
> (b) the amount of interest (if any) actually paid by P in that year on the loan.

[674] Section 742B of the ITA 2007.
[675] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.2.
[676] Maston *Tolley's UK Taxation of Trusts 2018-19* para 17.53.

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(2) In this section and section 742D the “official rate”, in relation to interest, means the rate applicable from time to time under section 178 of the Finance Act 1989 for the purposes of Chapter 7 of Part 3 of ITEPA 2003.”[677]

Where beneficial loans are concerned, the value of the benefit is equal to the official rate of interest on the outstanding loan amount. If interest is levied on the loan, the benefit is limited to the difference between the rate of interest actually charged and the official rate of interest.

Benefits can also take the form of using trust property at less than an open market rental. In this context, the statutory valuation rules distinguish between movable and non-movable assets. For purposes of the former, section 742D outlines the formula that must be used.

The relevant section reads as follows:

“(1) The value of the benefit provided by making movable property available, without any transfer of the property in it, to a person (P) is, for each tax year in which the benefit is provided to P—

where—

CC is the capital cost of the movable property on the date when the property is first made available to P in the tax year,

D is the number of days in the tax year on which the property is made available to P (the relevant period),

R is the official rate of interest for the relevant period (but see subsection (3)),

T is the total of the amounts (if any) paid in the tax year by P—

(a) to the person providing the benefit, in respect of the availability of the movable property, or

(b) so far as not within paragraph (a), in respect of the repair, insurance, maintenance or storage of the movable property, and

Y is the number of days in the tax year.

(2) In subsection (1), in the meaning of CC, the “capital cost” of the movable property means an amount equal to the total of—

(a) the amount which is the greater of—

[677] Section 742C of the ITA 2007.

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(i) the amount or value of the consideration given for the acquisition of the movable property by, or on behalf of, the person (A) providing the benefit, and

(ii) its market value at the time of that acquisition, and

(b) the amount of any expenditure wholly and exclusively incurred by, or on behalf of, A for the purpose of enhancing the value of the movable property.

(3) If the official rate of interest changes during the relevant period, then in subsection (1) R is the average official rate of interest for the period calculated as follows.

Step 1 Multiply each official rate of interest in force during the relevant period by the number of days when it is in force.

Step 2 Add together the products found in Step 1.

Step 3 Divide the total found in Step 2 by the number of days in the relevant period.

(4) In subsections (1) and (2), "movable property" means any tangible movable property other than money."[678]

For purposes of valuing the use of immovable property, a largely similar method is used as in the case of movable assets. It is considered that the statutory value and market value will be almost identical in such cases. Section 742E provides the formula for this calculation.

The relevant section reads as follows:

"(1) The value of the benefit provided by making land available for the use of a person (P) is, for each tax year in which the benefit is provided to P, the amount by which—

(a) the rental value of the land for the period of the tax year during which the land is made available to P, exceeds

(b) the total of the amounts (if any) paid in the tax year by P—

(i) to the person providing the benefit, in respect of the availability of the land, or

(ii) so far as not within sub-paragraph (i), in respect of costs of repair, insurance or maintenance relating to the land.

(2) Subsection (1) does not apply in the case where the person providing the benefit transfers the whole of the person's interest in the land to P.

[678] Section 742D.

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(3) In subsection (1) "the rental value" of the land for a period means the rent which would have been payable for the period if the land had been let to P at an annual rent equal to the annual value.

(4) For the purposes of subsection (3) "the annual value" of land is the rent that might reasonably be expected to be obtained on a letting from year to year if—

(a) the tenant undertook to pay all taxes, rates and charges usually paid by a tenant, and

(b) the landlord undertook to bear the costs of the repairs and insurance and the other expenses (if any) necessary for maintaining the property in a state to command that rent.

(5) For the purposes of subsection (4) that rent—

(a) is to be taken to be the amount that might reasonably be expected to be so obtained in respect of a letting of the land, and

(b) is to be calculated on the basis that the only amounts that may be deducted in respect of services provided by the landlord are amounts in respect of the costs to the landlord of providing any relevant services.

(6) In subsection (5) "relevant service" means a service other than the repair, insurance or maintenance of the property." [679]

The third section 731 application condition can be described as the benefit causation condition. Before the charge on the benefit can apply, there must be a causal link between the asset used to provide the benefit and either the transfer or an associated operation.[680]

This means that not every benefit that an individual receives falls within the ambit of section 731. The tax charge is limited to those benefits where there is a nexus between the benefit and the transfer or an associated operation.

Section 732(1)(d) contains the fourth condition before the section 731 charge can apply.[681] This condition can be described as the taxable-transferor defence. The provision imposes a limitation on the applicability of section 731 if the individual is relevantly domiciled in the year of assessment.

[679] Section 742E.
[680] Section 732 subs (1)(c).
[681] Section 732 subs (1)(d).

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The provision uses the term relevantly domiciled as a qualification for the benefit charge. It is considered that relevantly domiciled is an opaque term. Section 732(4) provides the following definition.

The relevant section reads as follows:

> "(4) For the purposes of subsection (1)(d), the individual is "relevantly domiciled" at any time if at that time—
>
> (a) the individual is domiciled in the United Kingdom, or
>
> (b) the individual is regarded for the purposes of section 718(1)(b) as domiciled in the United Kingdom as a result of section 835BA having effect because of Condition A in that section being met."[682]

Based on the above definition, an individual is not considered to be relevantly domiciled if the individual is not actually UK domiciled, or if the individual is not a formerly domiciled UK resident.

This means that if an individual is relevantly domiciled, the section 731 benefit charge cannot apply. However, in such circumstances, the individual may be subject to tax in terms of section 720 or section 727. This can be explained by the fact that such an individual does not qualify for the protected trust relief available to non-residents.

The fifth and last section 731 application condition can be termed the capital condition. Section 732(1)(e)(e) prevents double taxation from occurring. The provision provides that if the individual beneficiary is already subject to income tax under another provision, the section 731 charge cannot apply in such circumstances.[683]

Only if all five of the section 731 application conditions have been satisfied can one conclude that the individual beneficiary has received a taxable benefit.[684] The next part is to calculate the amount of income that is subject to section 731. However, section 732 does not quantify the tax charge, instead, it refers to section 733.

The relevant section reads as follows:

[682] Section 732 subs (4).
[683] Section 732 subs (1)(e).
[684] Section 732 subs (1).

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"(2) Income is treated as arising to the individual for income tax purposes for any tax year for which section 733 provides that income arises.

(3) Also see that section for the amount of income treated as arising for any such tax year."[685]

If one turns to section 733, one encounters the formula that must be used in calculating the amount of income that will be subjected to tax in accordance with section 731.[686] The provision further determines in which year the income arises and when the tax charge is payable.

The relevant section reads as follows:

"(1) To find the amount (if any) of the income treated as arising under section 732(2) for any tax year in respect of benefits provided as mentioned in section 732(1)(c) take the following steps. Step 1Identify the amount or value of such benefits received by the individual in the tax year and in any earlier tax years in which section 732 has applied. The sum of those amounts and values is "the total benefits". Step 2 Deduct from the total benefits the total amount of income treated as arising to the individual under section 732(2) for earlier tax years as a result of the relevant transfer or associated operations. The result is "the total untaxed benefits" except that, where any of that income is matched deemed income for the purposes of section 731(1A), that matched deemed income is to be deducted only so far as it is matched deemed income on which tax has been charged under section 731 for an earlier tax year. Step 3Identify the amount of any income which—

(a) arises in the tax year to a person abroad, and

(b) as a result of the relevant transfer or associated operations can be used directly or indirectly for providing a benefit for the individual. That amount is "the relevant income of the tax year" in relation to the individual and the tax year. Step 4Add together the relevant income of the tax year and the relevant income of earlier tax years in relation to the individual (identified as mentioned in Step 3). The sum of those amounts is "total relevant income"

Step 5 Deduct from total relevant income—

(a) the amount deducted at Step 2, and

(b) any other amount which may not be taken into account because of section 743(1) and (2) (no duplication of charges). The result is "the available relevant

[685] Section 732 subs (2).

[686] Section 733.

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> income". Step 6Compare the total untaxed benefits and the available relevant income. The amount of the income treated as arising under section 732(2) for any tax year is the total untaxed benefits unless the available relevant income is lower. If the available relevant income is lower, it is the amount of income treated as so arising.
>
> (2) Subsection (1) is subject to section 734 (reduction in amount charged: previous capital gains tax charge)." [687]

In broad terms, the income under section 731 is limited to the lesser of the value of the benefit and the amount of relevant income in relation to that individual. This is in contrast to section 720, which in general, imposes a charge on the whole of the income accruing to the person abroad.[688] However, the computation is not that simple.

In order to derive at the amount of income, the provision outlines six steps that must be followed.[689] As a point of departure, it must be observed that the provision is incredibly complicated and full of defects. However, one must adopt a construction that delivers a sensible result.

The steps can be summarised as follows:[690]

Step 1: Total benefits
Step 2: Total untaxed benefits
Step 3: Relevant income
Step 4: Total relevant income
Step 5: Available relevant income
Step 6: Total section 731 income

The first step provides that one must identify the total benefits. This is equal to the sum of the benefits in the current year of assessment plus any qualifying benefits received in previous tax years.[691]

Despite the obscure use of the word such, it is considered that the benefits referred to in the current tax year under subsection 1, are limited to those benefits that

687 Section 733.
688 Section 720 subs (2).
689 Section 733 subs (1).
690 Kessler *Taxation of Non-Residents and Foreign Domiciliaries* paras 36.1 and 36.2.
691 Section 733 subs (1) of the ITA 2007.

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satisfy all five of the section 731 application conditions.[692] In other words, it does not extend to those benefits that only comply with section 732(1)(c).

Similarly, the reference to such benefits in prior tax years must be read to mean only those benefits to which section 732 applies regarding the circumstances of the transfer or the individual in the earlier year.[693]

The second step of the calculation revolves around ascertaining the value of the total untaxed benefits. To this extent, step 2 basically provides that one must deduct the individual's income from previous years that were already subject to section 731 from the total benefit amount as calculated in step 1.[694] The result of the aforesaid is the total untaxed benefits.

Aside from the above, deductions are also available for previous CGT and previous settlement charges. However, it is considered that these deductions are only applicable in a very limited set of circumstances.[695] For this reason, it will not be further discussed in this dissertation.

The third step of the calculation pertains to the determination of the quantum of relevant income. It is considered that the concept of relevant income should not be viewed in the abstract but must rather be viewed in relation to an individual and a specific year of assessment.[696]

Step 3 provides that the relevant income is all the income that arises to the person abroad and that can be used to provide the individual with a benefit as a result of the relevant transaction.[697] In this context, income that arises to the person abroad has the same meaning as under the transfer of asset condition.[698]

Although the income may constitute income that arises to the person abroad, the income must be able to be applied for the benefit of the UK resident individual.[699] If this is not possible, it cannot be regarded as relevant income. However, if the contingency is so remote, said income will not be included in the relevant income.

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[692] Section 732 subs (1).
[693] Section 732.
[694] Section 733 subs (1).
[695] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.1 and 36.2.
[696] Paras 36.1 and 36.2.
[697] Section 733 subs (1) of the ITA 2007.
[698] Section 648 of the Income Tax (Trading and Other Income) Act 2005.
[699] Section 733 subs (1)(b) of the ITA 2007.

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In addition, if the person abroad uses the income to pay for expenses, it will reduce the available income that can be used for the benefit of the individual, and hence, result in a reduction of the relevant income.[700] This is also the case for distributions made from the income, and taxes paid.

Once income is designated as relevant income, the classification will remain, regardless of the form the income takes.[701] In other words, even if the person abroad sells the underlying asset but re-invests the proceeds, the income that arises from the new investment will also be regarded as relevant income. This phenomenon will only cease if the income can no longer be used for the individual's benefit.

Pertaining to the timing of the determination, it is considered that one looks to the position at the later of: [702]

1. the end of the tax year in which the relevant income has accrued, or
2. the end of the tax year in which the benefit is received.

If a benefit is conferred on an individual, but the benefit is not taxed under section 731 in the year that the income arises as a result of a lack of relevant income, the benefit can be taxed as a capital gain in that year. However, if the requirements for a capital gain are not satisfied, the application of section 731 will take preference in the following years of assessment.

After the relevant income has been identified, one has all the required information to continue to the next step. Following from the former, the fourth step of the calculation deals with the compilation of the total relevant income.

Step 4 provides that the total relevant income is comprised of the sum of the relevant income in relation to the individual for the current tax year plus the relevant income of previous years of assessment.[703] In this context, the individual refers to the person identified in step 3. Or, put differently, the individual that can benefit from the income that arises to the person abroad.

This brings one to the fifth step of the calculation, which revolves around determining the available relevant income. To this extent, step 5 provides that the individual's income of previous years which was already subjected to section 731,

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[700] Maston *Tolley's UK Taxation of Trusts 2018-19* para 17.53.
[701] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 36.1 and 36.2.
[702] ParaS 36.1 and 36.2.
[703] Section 733 subs (1) of the ITA 2007.

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must be deducted from the total relevant income.[704] This is the same amount that was deducted in step 2 to ascertain the total untaxed benefits. In addition, step 5 states that any other amount that cannot be taken into account for the tax charge under section 731, as a result of the non-duplication of charges rule must also be deducted.

Finally, one reaches the last step of the computation. Step 6 concerns the total section 731 income. In other words, the amount of income that is treated to arise to the individual in the year of assessment in terms of section 732(2). The total section 731 income is the lesser of the total untaxed benefits and the available relevant income.[705] The result of the aforesaid is the amount of income that will be subjected to the tax charge under section 731.

Unlike the other charging provisions in the transfer of assets regime, section 731 is not limited to UK resident individuals. Instead, under certain circumstances, the provision imposes a tax charge on non-residents as well.[706] This adds to the already complex nature of the provision.

The relevant section reads as follows:

> "(1A) But where the individual is non-UK resident for the tax year in which a benefit is received, there is a charge to tax under this section on any matched deemed income—
>
> (a) only so far as that matched deemed income would under section 735A (if it applied also for this purpose) be matched with an amount of relevant income that is protected income for the purposes of section 733A(1)(b)(i) (see sections 721(3BA) and 728(1B)), and
>
> (b) only if—
>
> (i) the individual is the settlor of the settlement concerned, or
>
> (ii) the benefit is received by the individual at a time when the individual is a close member of the family of the settlor of that settlement." [707]

Based on the above, one can infer the following requirements before a tax charge can be levied on a non-resident individual. The provision makes more sense if one regards the requirements as categories of conditions. In other words, each condition has

[704] Section 733 subs (1).
[705] Section 733 subs (1).
[706] Section 731 subs (1A).
[707] Section 731 subs (1A).

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various sub-requirements that need to be satisfied. In broad terms, the sets of conditions can be described as:

1. matched deemed income;
2. matched to protected income; and
3. the benefit received by the settlor or close family.

Only the non-resident's income that adheres to all the conditions above can attract a tax charge under section 731. The income that falls short of any of the conditions will not be subject to section 731.

First, one must identify the matched deemed income. For this purpose, section 731(1B) contains the definition of matched deemed income. Basically, matched deemed income is all the income that complies with the section 731 application conditions.[708] If the remittance basis applies, it will also include income under section 735A.[709]

The relevant section reads as follows:

> "(1B) For the purposes of subsection (1A)—
>
> (a) matched deemed income" means income which—
>
> (i) is treated by section 732 as arising to the individual, and
>
> (ii) would, if section 735A applied also for this purpose, be matched under that section with the benefit, and
>
> (b) a person is a close member of the family of the settlor of a settlement if the person is—
>
> (i) the settlor's spouse or civil partner, or
>
> (ii) a child of the settlor, or of a person within sub-paragraph (i), if the child has not reached the age of 18; and section 733A(7) (persons living together) applies also for the purposes of paragraph (b)."[710]

The second condition is that the matched deemed income must be matched to the protected income. Subsection (a) of section 731(1A) serves to restrict the application

[708] Section 731 subs (1B).
[709] Section 735A.
[710] Section 731 subs (1B).

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of the provision. It provides that the section 731 income is only limited to the extent that the matched deemed income can be matched to protected income.[711]

The last condition pertains to the familial connection of the individual beneficiary to the settlor of the settlement. Section 731(1A)(b) further qualifies the operation by only applying if the beneficiary is the settlor of the settlement or if the beneficiary is closely related to the settlor.[712] In this context subsection (b) of the provision outlines what family link is considered sufficient for a person to be regarded as closely related.

This means that if the benefit is received by a non-resident individual that is not the settlor, nor related to the settlor, the section 731 charge will not apply.

Conversely, if the individual beneficiary is a non-resident, but related to the settlor, the charge will depend on the settlor's residency status. For one, if the settlor is a UK resident, the settlor will be chargeable under section 733A.[713] If the settlor is non-resident, it is considered that section 731 cannot apply.

The last part of the accompanying section 731 provision deals with special rules that only apply in very limited circumstances.[714] In addition to the former, these rules are substantially similar to the onward gift charging provisions found under the protective trust regime. However, the special rules under section 731 have a much wider ambit compared to the onward gift rules.[715] In addition, the charge under section 731 takes precedent over the charges under the protective trust regime. Aside from the brief overview below, the rules will not be further discussed in this dissertation.

In broad terms, these special rules can be divided into the following two main categories:

1. the settlor attribution rule; and
2. the onward gift rule.

The settlor attribution rule targets those cases where section 731 cannot apply to the beneficiary itself since the beneficiary is a non-resident individual, or has adopted the remittance bases.[716] In such a case, if the beneficiary is a close family member of the settlor of a protected trust, and the settlor is also a UK resident, the settlor is potentially

[711] Section 731 subs (1A)(a).
[712] Section 731 subs (1A)(b).
[713] Section 733A.
[714] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* paras 36.1 and 36.2.
[715] Maston *Tolley's UK Taxation of Trusts 2018-19* para 25.21.
[716] Section 733A of the ITA 2007.

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liable for the benefit charge. In such an instance, the charge is on the lower of the value of the benefit and the amount of protected income.

The onward gift rules deal with the situation where an individual that received a benefit from the income that arise to a person abroad passes the benefit on to another person.[717] By virtue of the provisions, tax liability is imposed on the recipient of the subsequent benefit.[718] Under other conditions, the settlor is held liable for the charge on the benefit.[719] It goes without saying that various permutations of the aforesaid scenario are possible, and the successive provisions cover a wide range of potential circumstances.

5 3 3 5 Exceptions

While the transfer of assets regime contains various charging provisions that target different scenarios, the same exceptions apply to all the charging provisions. If an exception is successfully invoked, no tax liability will ensue under that specific charging provision.[720] In other words, the exception functions as a defence to the operation of the provision and must be raised by the taxpayer.

In order to prevent a tax charge under a charging provision, one must either demonstrate that the purpose of the arrangement was not for tax avoidance or that it was a genuine commercial transaction.[721] Collectively, these exceptions can be described as the motive defence.

The provisions distinguish between relevant transactions that occurred before 2005 and those relevant transactions that took place post-2005.[722] Depending on which category the specific transaction falls into, it is governed by different sections which have their own requirements.

In addition to the above, provision is further made for transactions that have aspects that may satisfy both the aforesaid categories.[723] In such cases, there are special apportionment rules to consider. Similarly, special rules exist if the defence is

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[717] Section 733B.
[718] Section 733C and 733D.
[719] Section 733E.
[720] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.62.
[721] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* paraS 36.1 and 36.2.
[722] HM Revenue & Customs "Transfer of assets abroad: Overview of ITA2007/S736 – 742 exemption from liability" (07-01-2023) *HMRC* <https://www.gov.uk/hmrc-internal-manuals/international-manual/intm600040> (accessed 01-04-2022).
[723] Section 733 of the ITA 2007.

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applicable to certain tax years, but in other years the requirements are not met.[724] Lastly, provision is made for a European Union ("EU") defence,[725] but the courts nullified the statutory defence for non-compliance to EU regulations.[726] For the time being, the statutory EU defence has been replaced by a judicial defence. For purposes of this dissertation, the discussion will be limited to the exceptions for transactions after 2005.

The relevant section reads as follows:

"(1) This section applies if all the relevant transactions are post-4 December 2005 transactions.

(2) An individual is not liable to income tax under this Chapter for the tax year by reference to the relevant transactions if the individual satisfies an officer of Revenue and Customs—

(a) that Condition A is met, or

(b) in a case where Condition A is not met, that Condition B is met.

(3) Condition A is that it would not be reasonable to draw the conclusion, from all the circumstances of the case, that the purpose of avoiding liability to taxation was the purpose, or one of the purposes, for which the relevant transactions or any of them were effected.

(4) Condition B is that—

(c) all the relevant transactions were genuine commercial transactions (see section 738), and

(d) it would not be reasonable to draw the conclusion, from all the circumstances of the case, that any one or more of those transactions was more than incidentally designed for the purpose of avoiding liability to taxation.

(5) In determining the purposes for which the relevant transactions or any of them were effected, the intentions and purposes of any person within subsection (6) are to be taken into account.

(6) A person is within this subsection if, whether or not for consideration, the person—

(a) designs or effects, or

(b) provides advice in relation to, the relevant transactions or any of them.

(7) In this section—

"revenue" includes taxes, duties and national insurance contributions,

[724] Section 741.
[725] Section 742A.
[726] [2021] EWCA Civ 1438.

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> "taxation" includes any revenue for whose collection and management the Commissioners for Her Majesty's Revenue and Customs are responsible."[727]

For an individual to successfully rely on the protection of section 737, one must satisfy either one of the following two conditions:

1. that there was no tax avoidance purpose; or [728]
2. that the arrangement is a genuine commercial transaction.[729]

The first line of defence is for an individual to show that tax avoidance was not one of the purposes of the transaction. In order to successfully rely on the defence, it is not sufficient to show that avoiding tax was not the primary purpose but merely a supplementary consideration for the transaction.

As a point of departure, the term tax avoidance is complicated, and emotionally charged, and in practice, the term is constantly abused. Currently, it is debatable what conduct constitutes acceptable tax mitigation, what the exact ambit of tax avoidance is, and at what point it transcends into tax evasion.[730] The answers to the aforesaid largely depend on one's perspective. However, the fact remains that even though academics and lay persons alike widely use the terms, there is seldomly consensus on the exact definitions and boundaries.[731] For the purposes of this dissertation, it is sufficient to limit the discussion of these terms to a brief overview. A more detailed discussion falls outside the scope of the dissertation.

Strictly speaking, tax evasion is considered to consist of wilful and conscious non-compliance with the laws of a taxing jurisdiction. In other words, tax evasion can be described as an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means.[732]

In contrast, tax avoidance involves the attempt to reduce the amount of taxes otherwise owed by employing legal means. However, in certain cases, the borderline between evasion and avoidance may be difficult to define. This is equally true for the line between avoidance and mitigation.

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[727] Section 77 of the ITA 2007.
[728] Section 737 subs (3).
[729] Section 737 subs (4).
[730] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* paras 36.1 & 36.2.
[731] Paras 36.1 and 36.2.
[732] Paras 36.1 and 36.2.

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In *Willoughby*,[733] the court held that:

> "The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option."

According to HMRC, tax avoidance is any action taken to obtain a tax advantage in a way that Parliament did not intend or would not have intended had the matter been put before it.[734]

In order to ascertain the purpose of the transaction, one must first identify the intention of the parties involved. Only once it has been determined that reducing their tax liability was one of the reasons for effecting the transaction can one classify the conduct into the appropriate category. [735]

The question pertaining to the parties' purpose is subjective since it all depends on what is in the minds of the parties. For such enquiry, one must take all facts and surrounding circumstances into account. It is considered that an exemption to the operation of the provision is not due solely based on an assertion by individuals that tax avoidance was not their subjective intention, because such submissions may not be credible in the light of other relevant facts. Instead, one must consider the following objective questions: [736]

1. Whether the transfer did reduce tax significantly; and
2. Whether the tax reduction was foreseeable at the time of the transfer.

If the tax reduction was not foreseeable, it is not likely to have been the purpose of the transaction in question. The converse is also true, the fact that a tax advantage is

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733 [1997] STC 995 (HL)

734 HM Revenue & Customs "Transfer of assets abroad: Overview of ITA2007/S736 – 742 exemption from liability" (07-01-2023) *HMRC*.

735 Kessler *Taxation of Non-Residents and Foreign Domiciliaries* paras 36.1 and 36.2.

736 Paras 36.1 and 36.2.

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objectively foreseeable as a consequence of the transfer may be cogent evidence of a subjective purpose.[737]

Usually, one can equate a person's purpose with the foreseeable consequences of the specific activity, but this is not always the case. To this extent, it is possible that the individual may not have foreseen the advantage, even though a reasonable person might have done so. In addition, the individual may have been aware of the advantage, but it may nevertheless not properly be classified as their "purpose".

In *IRC v Brebner*,[738] the court held that "the fact that there are two ways of carrying it out – one by paying the maximum amount of tax, the other by paying no, or much less, tax – it would be quite wrong, as a necessary consequence, to draw the inference that, in adopting the latter course, one of the main objects is, for the purposes of the section, avoidance of tax."

Considering the above, it is suggested that if a taxpayer can satisfy section 737(4), which requires the transaction to be a genuine commercial transaction, it is likely that the purpose defence will also be satisfied.

Based on all the available evidence, if it has been determined that one of the purposes of the transaction was to reduce tax, one must classify such conduct into tax avoidance, tax mitigation or tax evasion. It is considered that such classification is a question of law and should be ascertained objectively.[739] In other words, in which category the individual intended the conduct to fall is irrelevant.

Section 737(5) extends the ambit of the enquiry beyond merely the taxpayer. To this extent, the provision provides that for purposes of ascertaining the purpose of the transaction, one must consider the intensions of all parties.[740] The provision subsequently refers to subsection (6) of the provision, which qualifies which parties are included in the reference in subsection (5).[741]

Section 737(6) provides that any person who offers advice to the taxpayer or who designs or gives effect to the transaction will be subject to subsection (5) of the provision.[742] This means that if any of the above-mentioned persons acted with the

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[737] Para 36.3.
[738] [1967] 2 AC 18.
[739] Maston *Tolley's UK Taxation of Trusts 2018-19* para 23.2.
[740] Section 737(5) of the ITA 2007.
[741] Section 737 subs (6).
[742] Section 737 subs (6).

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intention of achieving a tax reduction for the taxpayer, it may well be that the purpose of the transaction is to reduce their tax liability.

According to *Ebsworth v HMRC*,[743] the mere fact that tax advice has been obtained is not, on its own, an indication that the obtaining of a tax advantage is the main purpose of the arrangement in question.

In terms of section 737(4), the second option is for the taxpayer to show that the transaction is a genuine commercial transaction.[744] For purposes of this subsection, the term commercial is defined in section 738.[745] It is considered that the use of the word genuine does not alter the meaning of commercial as defined.

The relevant section reads as follows:

"(1) For the purposes of section 737, a relevant transaction is a commercial transaction only if it meets the conditions in subsections (2) and (3).

(2) It must be effected—

(a) in the course of a trade or business and for its purposes, or

(b) with a view to setting up and commencing a trade or business and for its purposes.

(3) It must not—

(a) be on terms other than those that would have been made between persons not connected with each other dealing at arm's length, or

(b) be a transaction that would not have been entered into between such persons so dealing.

(4) For the purposes of subsection (2), making investments, managing them or making and managing them is a trade or business only so far as—

(a) the person by whom it is done, and

(b) the person for whom it is done, are persons not connected with each other and are dealing at arm's length."[746]

The term commercial transaction is narrowly defined. One can even describe the definition as artificial. The way in which the definition is phrased, one can infer that it

[743] [2009] FTT 199 (TC).
[744] Section 737 subs (4) of the ITA 2007.
[745] Section 738 subs (1).
[746] Section 738.

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is intended to be an exhaustive definition. However, it is considered that it does not serve any real purpose.

In the general sense, A transaction made with a gratuitous intent is not commercial. By contrast, a transfer intended to make money is commercial. However, it is considered that there is no single factor that will determine whether a transaction is commercial or not. Instead, one must examine all the facts and circumstances of the case.

The provision outlines two requirements that need to be satisfied before a transaction will constitute a commercial transaction. First, section 738(2) provides that a transaction is a commercial transaction if it is effected in the course of an already established trade or business or if it is effected for the aim of commencing a trade or business.[747]

This means that transactions that are regarded as commercial in the normal sense of the word will not satisfy the requirement unless it furthers the trade or business. Hence, it is considered that the meaning adopted is too restrictive.

Secondly, section 738(3) states that the transaction must be an arms-length transaction.[748] In other words, the transaction must be on market-related terms and must be in a form that is regarded as acceptable between unconnected parties. If the transaction deviates from the above, it will fall short of the definition's requirements.

Aside from the transfer, section 737(8) extends the ambit of the provision to also apply to any associated operations.[749] This means if an associated operation has a tax avoidance purpose, it can result in the entire arrangement missing out on relying on the motive defence.

The relevant section reads as follows:

"(8) If—

(a) apart from this subsection, an associated operation would not be taken into account for the purposes of this section, and

(b) the conditions in subsections (2) to (4) are not met if it is taken into account, because of—

(i) the associated operation, or

[747] Section 738 subs (2).
[748] Section 737 subs (3).
[749] Section 737 subs (8).

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(ii) the associated operation taken together with any other relevant transactions, it must be taken into account for those purposes." [750]

Differently put, in order to succeed with the motive defence, the taxpayer must show that not only does the specific transfer comply with either of the defence conditions, but any associated operation to the transfer must also comply with the aforesaid conditions.

5 3 4 Protected trusts

The protected trust regime is a subset of the tax system, which governs the use of offshore trusts in the UK. More specifically, it applies to offshore trusts with foreign domiciliaries.[751] Under the protected trust regime, all trusts that are established by non-UK domiciliaries are afforded a protected trust status. This protection remains in place even after the settlor is deemed domiciled under the new domicile rules. For the purpose of this dissertation, the discussion of the protected trust regime will be limited to a high-level overview.

These so-called protected trusts are exempt from all the tax charges discussed throughout the chapter. However, the relief is only available if all the specific conditions of the charging provision are met and limited to the extent that the income is regarded as protected foreign source income.[752]

Unfortunately, there is no universal definition for what constitutes protected foreign source income. Instead, almost every provision adopts a different meaning.[753]

If the protected trust qualifies for the relief from the settlor charging provisions or the charges under the transfer of asset regime, the income that arises to the trust is not chargeable to tax in terms of any of the aforesaid provisions but said income is only subject to tax when the income is distributed to beneficiaries.[754] In such a case,

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[750] Section 737 subs (8).
[751] HM Revenue & Customs "Trust Protections and Capital Gains Tax changes" (undated) *Gov.uk* <https://www.gov.uk/government/publications/trust-protections-and-capital-gains-tax-changes> (accessed 07-04-2022).
[752] HM Revenue & Customs "Trust Protections and Capital Gains Tax changes" (undated) *Gov.uk*.
[753] Sections 721A and 279A of the ITA 2007; sections 628A and 630A of the Income Tax (Trading and Other Income) Act 2005.
[754] Maston *Tolley's UK Taxation of Trusts 2018-19* para 26.7.

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the income will either be assessed to tax under the general principles or in terms of the special rules that are only applicable to protected trusts.

In addition to the relief offered, the protected trust regime also introduces a range of new anti-avoidance provisions.[755] These provisions are specifically designed to target arrangements that use offshore trusts.

The purpose of these anti-avoidance provisions is to supplement the settlor charging provisions. Previously before the enactment of these provisions, under certain circumstances, it may have been possible to provide benefits to non-resident beneficiaries without triggering the settlor charging provisions.[756]

The protective trust charges apply to benefits conferred to non-resident beneficiaries by offshore trusts. However, the operation is only limited to those offshore trusts where the settlor is a UK resident and those situations where the benefits are provided to close family members of the settlor.[757] The type of benefits contemplated in this section is the same benefits that are subject to the benefit charge under section 731.[758] In actual fact, these charges overlap greatly, but the protected trust charges have a much narrower ambit.

By virtue of the operation, a tax charge is levied on the settlor for the value of the benefit received by the beneficiary.[759] In certain instances, the tax charge is imposed on subsequent recipients of the benefit.[760]

5 3 5 Conclusion

Since the trust concept originated in the UK, it is probably not surprising that the UK has one of the most elaborate anti-avoidance provisions for the use of trusts. Despite the unmatched ambit of the various SAARs, the UK still subscribes to the principal position that income that is received by or that accrues to a trust must only be subject to tax once throughout the trust relationship. Thus, for the taxation of trusts, the UK mainly uses the credit system and also views the trust structure as a hybrid flow-

[755] Section 643A, 643B, 643C, 643D, 643E, 643F, 643G, 643H, 643I, 643J, 643K, 643L, 643M and 643N of the Income Tax (Trading and Other Income) Act 2005.
[756] Maston *Tolley's UK Taxation of Trusts 2018-19* para 26.21.
[757] Section 716 (1)(b)(ii) of the ITA 2007.
[758] Section 731.
[759] Section 643A.
[760] Section 643I.

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through entity.[761] Even though the income may be subjected to tax on multiple fronts, the tax credits received essentially counter-acts double taxation from occurring.

Unlike most other countries, the UK uses both a person's residency status and domicile as determinants for levying taxes.[762] This means that the combination of the aforementioned factors influences one's tax liability. As is generally the case with most individual taxpayers, trusts that are resident in the UK are typically taxed on their worldwide receipts and accruals, while non-UK resident trusts are normally not subject to UK taxation on any foreign receipts and accruals. Instead, non-resident UK trusts are only liable to UK taxation on UK source income.[763]

As a point of departure, all trust income is received by the trustees, regardless of whether they are beneficially entitled to said income.[764] Trustees are further taxed on any distributions made to beneficiaries.[765] Beneficiaries are, in turn, taxed on the income received.[766] Under certain circumstances, the beneficiary can receive the income directly, thereby circumventing the income flowing through the trust.[767] In other cases, it is also possible that income is deemed to be that of the settlor, even though the settlor has not received the income.[768] In such a case, the trustees will still pay the tax liability, but it is taxed in the hands of the settlor, who bares the ultimate responsibility. In all of the aforementioned scenarios, an appropriate tax credit is provided to relieve possible double taxation.

The purpose of a SAAR is to prevent specific arrangements that are regarded as abusive or unwanted. Such arrangements attempt to derive an unintended tax benefit or circumvent a taxpayer's tax obligation. If successful, the arrangement will result in an unjust reduction in the taxpayer's tax liability.

By virtue of the SAARs, income received by or that accrues to a trust is deemed to be that of the settlor and taxed accordingly in the settlor's hands. However, it is also possible that the operation of a SAAR deems the income of the trust to be that of a beneficiary and taxes said income accordingly. Moreover, under specific

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[761] Wheeler (2011) *WTJ* 247 347.
[762] Booth *Booth and Schwarz: Residence, Domicile and UK Taxation* 9.
[763] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* paras 20.17 and 20.18.
[764] Para 31.2.
[765] Chamberlain & Whitehouse *Trust Taxation* 8.
[766] Maston *Tolley's UK Taxation of Trusts 2018-19* para 6.1.
[767] Chamberlain & Whitehouse *Trust Taxation* 29.
[768] Kessler *Taxation of Non-Residents and Foreign Domiciliaries* para 33.3.

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circumstances, the application of a SAAR can impose the liability to tax on someone outside the trust relationship.

Based on the preceding discussion, the UK has an exceptionally comprehensive set of SAARs that specifically focuses on the use of trusts. Instead of having a collection of single provisions that target specific scenarios, the SAARs are divided into various sub-regimes. Each of these so-called sub-regimes consists of a range of provisions, which governs almost every aspect pertaining to the overarching theme. Every sub-regime focuses on a specific type of abuse, which ultimately ensures that all income received by or that accrues to a trust undergoes the appropriate tax treatment at the correct time. Cumulatively, these anti-avoidance provisions cover an extremely wide range of scenarios and permutations. However, before any of these anti-avoidance provisions can apply to any given case, all the requirements of the specific provision must be satisfied.

However, with such an array of SAARs, it has also resulted in unmatched complexity. Not only is the legislation extensive, but the anti-avoidance provisions are also extremely intricate. In addition, in many cases, the provisions are poorly drafted, which results in various unintended consequences. Compounding the problem, is the ongoing amendments and additions. Understandably, the SAARs must evolve as the avoidance arrangements develop, but this patchwork nature of drafting results in a collection of incoherent provisions.

Under UK law, the SAARs that are most relevant to trusts can broadly be divided into the following sub-regimes:

1. settlor-interested trusts;
2. transfer of assets; and
3. protected trusts.

The settlor-interested trust regime, or so-called settlor charging provisions, contains a collection of provisions that target arrangements whereby settlors circumvent their tax liability or unduly reduce their tax charge by using income-splitting structures. Each of the charging provisions within the regime focuses on preventing a specific scenario or variation. Section 624 is aimed at the situation where the settlor retains an interest in the property, but the income of said property is paid to someone else. Conversely, section 629 covers income-splitting arrangements between parents and their minor children, while section 633 is aimed at preventing the settlor from obtaining any benefit

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from the settlement by exploiting the differences in the tax rates applicable to the settlor and the trust.

The transfer of assets regime is a set of anti-avoidance provisions that focuses on arrangements whereby taxpayers shift income-producing assets to non-resident trusts in order to circumvent UK taxation. The regime consists of various charging provisions, which collectively operate to curb different forms of transfer arrangements. Each charging provision is aimed at a specific scenario, with its own set of defined requirements. All transfer arrangements can broadly be classified into one of the following three categories:

1. income payments;
2. capital sums; and
3. provided benefits.

Section 720 targets the situation where UK resident individual taxpayers transfer assets to a non-resident, which results in income becoming payable to the person abroad. Furthermore, section 727 is aimed at the situation where UK resident individual taxpayers transfer assets to a non-resident. Still, it carefully structures the arrangement in such a way that no power of enjoyment is afforded to the UK resident transferor. In other words, section 727 is intended to cover the gap in cases where taxpayers succeed in circumventing the income tax charge under section 720 while still receiving income from the non-resident trust. Finally, section 731 focuses on arrangements that are specifically crafted to fall outside the ambit of the other charging provisions but are nevertheless in line with the anti-avoidance objective. The latter provision predominantly applies to individuals who are not regarded as transferors but still receive a benefit from a non-resident person as a result of a relevant transfer.

In addition, the protected trust regime is a subset of the tax system, which governs the use of offshore trusts in the UK. More specifically, it applies to offshore trusts with foreign domiciliaries. Under the protected trust regime, all trusts that are established by non-UK domiciliaries are afforded a protected trust status. These so-called protected trusts are exempt from all the tax charges discussed throughout the chapter. However, the relief is only available if all the specific conditions of the charging provision is met and limited to the extent that the income is regarded as protected foreign source income. But once an event occurs that breaks the protected status, the entire trust will be subjected to the normal tax charges.

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While it is possible that more than one SAAR may be applicable to a specific case, the principal position remains that income can only be taxed once. Hence, if the income has already been taxed in accordance with one SAAR, the same income cannot be taxed by another provision. However, in order to promote clarity and to limit conflict, various preferential rules have been developed. Put differently, certain SAARs take precedence over that of other SAARs.

Depending on the specific SAAR, the resulting consequences can be once off, or the effect can be ongoing. For certain SAARs, maximum durations are imposed, whereafter the operation automatically ceases to apply. But other SAARs can continue in perpetuity if the link is not severed. However, the extent of the operation is determined by the specific facts and circumstances of the case.

Under most circumstances, the operation of a SAAR will only cease at the death of the targeted party or if the trigger is removed. This will typically take the form of the settlor or the transferer. However, what constitutes the trigger for the provision will depend on the specific circumstances and applicable SAAR. In some instances, the trigger event may be the settlor's interest in the settlement, but in others, it may be that the SAAR is invoked based on the type of the arrangement, the terms of the agreement, the transfer of an asset or merely an act by the trustees. Furthermore, in some limited cases, it is possible that the SAAR is triggered by an action performed, combined with a person's residency status and domicile.

If HMRC invokes a SAAR for the year of assessment, the taxpayer bears the onus to prove that the SAAR is not applicable. But, if more than one SAAR is potentially applicable, and the conflict is not regulated in the preferential rules, the taxpayer should have the choice in terms of which provision he is taxed. To this extent, the taxpayer must be able to furnish the HMRC with all facts and circumstances of the case. Only if the supporting documents can substantiate the taxpayer's submissions will the onus be successfully discharged. Notwithstanding the aforementioned, the trustees are obliged to disclose various information pertaining to the settlement in their tax returns.

Although it is evident that the UK has exceptionally sophisticated and comprehensive SAARs that target arrangements concerning trusts, the anti-avoidance framework is far from perfect. To the contrary, due to the way the system is developed, it almost defeats the whole objective. The problem is not that certain avoidance arrangements are not covered, but that the regime is so convoluted that it is virtually

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impossible to determine a taxpayer's tax liability with certainty. Compounding the issue is the fact that due to the unmatched reach of the provisions, in most cases, more than one SAAR is potentially applicable to the given circumstances. Further adding to the woes is the patchwork nature of drafting and the ambiguous terms used. The result is that uncertainty remains pertaining to the interpretation of key terms and the exact demarcation of the ambits of various provisions. However, overall, the UK's anti-avoidance framework is robust and effective in preventing abusive or unwanted arrangements. But the complexity and poor formulation hinder compliance, limiting the system's efficiency.

5 4 Belgium

The following paragraph aims to build on Chapter 4, which provided a brief overview of the Belgium tax system, the tax principles pertaining to trusts, the general ways trust income is treated for income tax purposes and an introduction to the Cayman tax regime. Against the aforesaid as backdrop, the discussion will now focus on the SAARs that are relevant to trusts.

Although Belgium has a range of anti-avoidance provisions that may have an effect on the parties in the trust relationship, it is only the Cayman tax regime that was specifically enacted for foreign legal constructs, specifically including trusts. For this reason, the discussion will only be limited to the Cayman tax.

Before commencing with the discussion, it should be noted that the author is not French or Flemish speaking, nor able to read any of the aforesaid languages. Instead, the author predominantly uses English to do his research. This is not per se, problematic, but if one considers the fact that in Belgium, the official legislation is only published in French and Flemish, the challenge is evident. Thus, unfortunately, the author had to rely on translating tools to use certain sources. Despite the language barrier, the best effort was made to ensure the accuracy of the translations.

It follows from the above, that a slightly different methodology will have to be adopted for the discussion on Belgium, compared to that used previously throughout the dissertation. In the prior paragraphs, the author quoted the relevant sections of the legislation, followed by an analysis of the provision. However, in light of the language barrier, this is nonsensical. Hence, the sections under discussion will not be quoted (in translated form) unless there is a clear benefit to doing so.

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5 4 1 Cayman tax regime

In line with the international trend toward increased scrutiny of offshore legal structures, Belgium introduced the so-called Cayman tax to curb tax avoidance.[769] The Cayman tax regime was enacted alongside other tax measures but is the first legislative framework specifically focusing on the perceived tax avoidance by using (non-resident) trusts and other low-tax legal entities in other jurisdictions.[770] To this extent, the regime targets private investment entities set up in low-tax foreign jurisdictions by Belgian resident private individuals and certain legal entities.[771] Under the new regime, Belgian tax authorities can look through targeted offshore structures to directly tax founders and third-party beneficiaries on income derived from such structures.[772]

The application of the Cayman tax regime is limited to Belgium resident taxpayers, which use foreign structures to avoid or reduce their income tax liability in Belgium, provided that all the other requirements are complied with.[773]

Thus, the Cayman tax regime can be described as a "look-through tax" or put differently as a fiscally transparent tax framework.[774] However, the level of fiscal transparency depends on the circumstances.[775] Hence, the regime is a form of imperfect fiscal transparency. By virtue of the Cayman tax, income received by or accrued to a qualifying foreign legal construct is deemed to be that of the founder and taxed accordingly in the founder's hands.[776] Conversely, all distributions from such

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[769] GD Goyvaerts "De kaaimantaks, een kritische beschouwing" (2015) *TFR* 867. . P Maufort, "La taxe caïman : état des lieux" (2021) *Revue Générale du Contentieux Fiscal* 219 – 251. M Gossiaux, "La réception du trust en droit fiscal belge" (2020) *Revue de planification belge et internationale* 316 – 322. T Afschrift, "La taxation par transparence des revenus des 'constructions juridiques' (première partie)" (2016) *Journal de Droit Fiscal* 5 – 45. T Afschrift, "La taxation par transparence des revenus des 'constructions juridiques' (seconde partie)" (2016) *Journal de Droit Fiscal* 65 – 112
[770] 867.
[771] GD Goyvaerts "New Belgian CFC legislation for private wealth structures or Cayman tax" (2016) 23 *JoIT&CP* 25.
[772] T Afschrift "La taxation par transparance des revenus des 'constructions juridiques' (premiere partie)" (2016) *JDF* 5-45.
[773] J Draye & A Nijs, "The Cayman tax: A game changer for the Belgian income tax treatment of trusts?" (2016) *Trusts & Trustees* 508-515.
[774] N Appermont & B Peeters "Belgian Cayman tax 2.0: Exit taxes worrisome for trust practitioners?" (2019) 25*Trusts & Trustees* 343-358.
[775] Afschrift (2016) *JDF* 65-112.
[776] *Code des impôts sur les revenus* 1992 art 5/1.

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legal constructs to the founder and to third-party beneficiaries resident in Belgium are deemed to be dividends for tax purposes.[777] Therefore, the Cayman tax regime disregards the existence of qualifying legal constructs and instead taxes the Belgium founders and beneficiaries.

This means that if a legal construct falls within the ambit of the Cayman tax regime, all undistributed income obtained by the legal construct will be deemed to be that of the founder and taxed in the founder's hands. In such a case, the Cayman tax functions as a full, fiscally transparent tax, which means the income retains its character for tax purposes when attributed to the founder.[778] As a result, the founder will be afforded the same tax treatment on the deemed income as would have been the case if the founder received the income directly. This is also the case, if income is distributed to the founder in the year that the income accrued to the legal construct. However, the text of the law leaves room for interpretation. The law can also be read to mean that when income obtained by the trust is distributed to a founder in the same fiscal year, the distribution should be taxed as a dividend in the head of the founder.[779] The Belgian tax authorities seemingly apply the former interpretation.

However, if the income received by the legal construct is not accumulated, nor distributed to the founder, but rather distributed to beneficiaries in the year of assessment, said distributions will be deemed to be dividends and taxed as such in the beneficiaries' hands.[780] In such a case, the regime operates as an imperfect fiscal transparent tax.[781] Hence, the income will not keep its qualification when received by the beneficiaries but will rather be classified as dividends. Consequently, any tax benefits that may have been available if the beneficiaries directly received the income would be lost.

Aside from being designated as the taxable parties in relation to the legal construct, the Cayman tax regime also imposes a reporting obligation on the above-mentioned parties.[782] In other words, all persons that are either classified as a founder

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[777] Article 18, para 1, 3.
[778] S Lust "The Belgian 'Cayman tax' and its impact on wealth and estate planning in Belgium" (2018) 24 *Trusts & Trustees* 230-237.
[779] N Appermont, C Costermans, E D'Hauwe, F Debelva, B Peeters, S Slaets, F Smet, AM Vandekerhove, L Vanneste, G Verachtert & V Vercauteren *De Kaaimantaks: Panta Rhei* (2019) 28.
[780] Preliminary Decision No 2015.538 of 22 December 2015.
[781] H Verstraete & L Migalksi "De 'kaaimantaks': Analyse en eerste bedenkingen" (2015) *VIP* 4-15.
[782] GD Goyvaerts "Belgium: A new obligation to declare foreign private wealth structures" (2014) 21 *Journal of International Tax, Trust and Corporate Planning* 46.

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or that receive a benefit from the legal construct are required to disclose their interest in said legal construct to the authorities in their annual tax returns.[783] Non-compliance with this transparency obligation is sanctioned with a fine of 6250 EUR per legal construct.[784]

The regime further contains various fictions to ensure that no amounts escape Belgium taxation.[785] In addition, ample provision is made for further specific anti-avoidance clauses, which authorities can invoke as a measure of last resort. Fortunately for taxpayers, provision is also made for some limited exceptions and defences.[786]

As a form of an anti-avoidance rule, in the instance that the assets, shares or economic rights of a legal construct are transferred to a jurisdiction with which Belgium does not engage in the exchange of information in tax matters, the operation of the fiscal fiction deems all the undistributed accumulated reserves to be disbursed, which in turn triggers the dividend tax on said distribution.[787] Equally, this fiction will also apply if all the assets, shares or economic rights of said legal construct are contributed to another legal entity, regardless of whether this legal entity is based in another jurisdiction as the existing legal construct.[788] Moreover, this so-called fictional liquidation can normally only apply if the transfer or contribution involves all the assets, shares or economic rights.[789] Hence, a partial transfer or contribution should not suffice However, due to the unclear wordings of the law, the question of whether this "fictional liquidation" is triggered in the case of a partial transfer is under debate in Belgian legal doctrine.

Furthermore, pertaining to undistributed accumulated reserves, it is deemed that the oldest income is distributed first in the case of a distribution by the legal construct.[790] The Cayman tax, therefore, applies a FIFO rule ("first in, first out"). The Belgian legislator introduced this rule to target the "untaxed historical reserves" of a

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[783] N Appermont "Foreign trust(-like) structures catch Belgium's attention" (2014) *Trusts & Trustees* 232-239.
[784] Appermont et al *De Kaaimantaks: Panta Rhei* 107.
[785] GD Goyvaerts "The changes introduced by the Belgian look-through taxation regulations or Cayman 2.0" (2019) 25 *Trusts & Trustees* 202 231.
[786] GD Goyvaerts "De kaaimantaks 2.0 – Een kritische commentaar bij de aanpassing van de kaaimantaks door de wet van 25 december 2017" (2018) *TFR* 642-697.
[787] *Code des impôts sur les revenus* 1992 art 5/1.
[788] Appermont et al *De Kaaimantaks: Panta Rhei* 29.
[789] Code des impôts sur les revenus 1992 art 2.
[790] Article 5/1 1, para 3.

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legal construct.[791] Closely related, the distribution will not be subject to the dividend tax, if it can be shown that the income has already undergone the appropriate tax treatment in Belgium.[792] However, by implication, this exemption does not extend to foreign taxes, which means that there is a real risk that double taxation will occur.

Combined, these rules imply that when a legal construct makes a distribution to a third-party beneficiary, the distribution will be taxed as a dividend unless it can be shown that the distribution is made up of trust assets which have already "undergone their tax regime" in Belgium, meaning that the founder has already paid income tax in the application of the Cayman tax regime.[793] Additionally, the oldest income of the trust is deemed, for tax purposes, to be distributed first.[794] If the trust was in existence before the introduction of the Cayman tax in 2015,[795] chances are that the trust has "historical reserves" which did not undergo their tax treatment in Belgium pursuant to the Cayman tax. These reserves will be deemed to be distributed and taxed as a dividend in the hands of the third-party beneficiary. Only when these "historical reserves" are deemed to have been fully distributed a tax exemption will be given to the third-party beneficiary on the basis that the distribution is composed of trust income which had "undergone its tax treatment in Belgium", in the sense that it has been taxed in the head of the founder in a fiscally transparent manner.

While the Cayman tax regime was initially introduced in 2015,[796] the regime has been amended numerous times since. These amendments not only considerably widened the regime's ambit but also introduced multiple fictions and hypotheses.[797] Although the legislator may have succeeded in their goal to close virtually all loopholes, the changes also significantly increased the complexity. Overall, it has resulted in confusion and uncertainty for taxpayers. Finally, important questions remain unanswered pertaining to compliance with the Belgium constitutional principles,[798] the interaction with domestic legislation and private international law,[799]

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[791] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[792] *Code des impôts sur les revenus* 1992 art 21, para 12.
[793] Appermont et al *De Kaaimantaks: Panta Rhei* 101.
[794] *Code des impôts sur les revenus* 1992 art 5/1, para 3.
[795] Goyvaerts (2016) *JoIT&CP* 27.
[796] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[797] Goyvaerts (2018) *TFR* 644.
[798] Draye & Nijs (2016) *Trusts & Trustees* 508-515.
[799] Verstraete & Migalksi (2015) *VIP* 7.

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as well as the adherence to the directives and regulations of the EU.[800] However, the aforesaid questions fall outside the ambit of this dissertation and hence, will not be addressed.

Based on the explanatory memorandums, it is clear that the Cayman tax regime was largely shaped around the authorities' scepticism and pre-conceived perceptions of trusts.[801] Clearly, the point of departure is that all trusts are used for devious activities.[802] Despite the prominent feature of trusts, the Cayman tax regime's ambit extends way beyond trusts. Instead, the regime applies to three broad categories of legal constructs, which means, amongst others, entities such as trusts, foreign foundations, companies, contract types and other exotic structures are included in the regime.[803]

Since the Cayman tax regime does not only apply to trusts, but a range of other legal entities as well, for purposes of this dissertation, the focus will be on the aspects relevant to trusts. However, in order to provide a comprehensive overview, the other aspects of the Cayman tax regime will be mentioned but not discussed in any detail.

Therefore, in order to achieve the aforesaid, the discussion will primarily be limited to the following topics:

1. the taxable parties;
2. qualifying legal constructs; and
3. exceptions.

5 4 1 1 Taxable parties

Although the Cayman tax regime applies to qualifying legal arrangements that are used to avoid Belgium income tax, it is not the legal arrangement itself that is the taxable person for purposes of the Cayman tax.[804] Consequently, for the operation of the Cayman tax regime, one must be able to identify a taxpayer to whom the income of a legal arrangement is attributed and who bares the reporting obligations.[805] Once

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[800] N Appermont & B Peeters "Kaaimantaks 2.0., exitheffingen en vrijheid van vestiging: troebel water?" (2018) 412 *Fiscoloog* 5-8.
[801] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[802] Appermont et al *De Kaaimantaks: Panta Rhei* 101.
[803] Appermont & Peeters (2019) *Trusts & Trustees* 5.
[804] N Appermont "De kaaimantaks: geen paradijselijke maatregel" (2015) 11 *AFT* 5-37.
[805] Goyvaerts (2015) *TFR* 867.

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identified, these taxpayers are regarded as the taxable parties, and hence, will be responsible for all tax duties of said arrangement.[806] In broad terms, such parties can be referred to as subjects.

Ever since the introduction of the duty to report, the legislator targeted both a founder and a beneficiary of potential income from a legal arrangement.[807] However, both capacities underwent various changes. Subsequently, the definition of the third-party beneficiary was abolished.[808]

Notwithstanding the aforesaid, the operation of the Cayman tax still focuses on two different subjects. On the one hand, a form of fiscal transparency continues to exist, whereby taxable income is attributed to a subject, who is qualified as a "founder".[809] Special attention is also paid to the subjects who receive benefits through a legal construct.[810] These subjects are no longer defined separately so that, in principle, all taxpayers who can obtain such income will be considered. However, just because a taxpayer qualifies as a subject, does not per se result in a tax liability. In order for such determination, one will have to consider all facts and circumstances.

By implication, it means factors such as to whom the income of the legal arrangement is actually paid or attributed, the tax residence of the recipient, the time of attribution or validation of the income, the nature of the income received and distributed, the impact of double tax treaties and whether or not an exception applies.[811]

Irrespective of the question of whether certain income is taxed on the part of a taxed subject, the obligation to disclose the existence of the legal arrangement must be considered separately.[812] Hence, the obligation to report the existence of said arrangement does not hedge on an actual tax charge.

While two different 'subjects' can play a role in the Cayman tax, it appears that, in the first place, importance is attached to the figure of the founder. For example, the explanatory memorandum clearly states the legal presumption that the founder of a legal arrangement can be considered the primary beneficiary of the income of said

[806] Appermont et al *De Kaaimantaks: Panta Rhei* 113.
[807] Appermont (2014) *Trusts & Trustees* 232.
[808] Goyvaerts (2019) *Trusts & Trustees* 213.
[809] Draye & Nijs (2016) *Trusts & Trustees* 511.
[810] Goyvaerts (2014) *Journal of International Tax, Trust and Corporate Planning* 46.
[811] Appermont et al *De Kaaimantaks: Panta Rhei* 113.
[812] Goyvaerts (2014) *Journal of International Tax, Trust and Corporate Planning* 46.

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arrangement.[813] Even though in practice, this might not always be the case. Furthermore, before the concept of third-party beneficiary was abolished, the Belgian tax ruling authority ruled that if a distribution is made to a founder who is also a third-party beneficiary, the capacity of founder prevails.[814]

It follows that the concept of founder is central to the operation of the Cayman tax regime. To this extent, in order to cover all possible scenarios and permutations, the definition of founder contains five different subcategories of founders. There is no explicit hierarchy between the various categories.[815] Instead, these categories are considered to be alternatives. Thus, if either definition applies to the circumstances, that subject is classified as the founder of that legal arrangement. Also, the definitions are not mutually exclusive.[816] Hence, depending on the circumstances, it is possible that one legal arrangement can have numerous founders. The addition of a new founder does not affect the status of the other founders.[817] However, this may have consequences for the valuation of income but will be particularly important for the reporting obligation.

Thus, the categories of founders can be described as follows:

1. the initiator;
2. the contributor;
3. the heir;
4. the holder of rights; and
5. the contractor.

5 4 1 1 1 The initiator

It is generally accepted that no legal construct can exist on its own, which means the mere existence of a legal construction presupposes that someone has created it.[818] The person who initiated the formation of said construct is regarded as the founder. It follows that the first category of founder is defined as either the natural person who

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[813] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[814] Preliminary Decision No 2016.745 of 6 December 2016.
[815] Afschrift (2016) *JDF* 65-112.
[816] Goyvaerts (2019) *Trusts & Trustees* 213.
[817] Verstraete & Migalksi (2015) *VIP* 4-15.
[818] JJ Couturier, B Peeters & E van der Velde *Belgisch Belastingrecht in Hoofdlijnen* (2018).

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has set up the structure outside the exercise of his professional activity or the legal person subject to tax on legal persons who has set up the structure.[819]

It is clear that the above definition is not very informative. Instead, it can be regarded as a circular reference. To say that the person who has founded the legal construct is the founder, does not provide much clarity. Regrettably, the Belgian legislator did not adopt a more comprehensive definition.

Although it is possible to turn to other fields of law for guidance in interpreting the aforesaid, one must be cognisant that the Cayman tax is primarily aimed at legal constructs established in foreign legal systems.[820] These jurisdictions may apply different principles to determine who qualifies as a founder under their domestic law. Alternatively, it is possible that such jurisdictions may not have a comparable concept. However, since the inception of the Cayman tax regime, the discrepancies between foreign legal systems and that of Belgium arguably posed the biggest challenge.[821] Notwithstanding the aforementioned, assistance with the interpretation can be sought from Belgian company and association law.

In terms of Belgium company law, the term founder broadly refers to the parties that appear on the deed of incorporation.[822] However, the word “appear” should not be understood too literally. It is also possible that third parties appear on behalf of a founder. In such case, the omission of the instructing party on the deed of incorporation does not deprive said party of the status of the incorporator.[823] After all, consent to the incorporation of a company can also be given by proxy, or even by means of one or more proxies.[824] Hence, these principles are also to be considered as appearing in the deed of incorporation and thus as incorporators. Similarly, under Belgium association law, there is also an unmistakable link between the parties considered to be founders and being mentioned in the deed of incorporation.

However, for the Cayman tax, the law applicable to the legal arrangement is not Belgian company or association law, but rather the jurisdiction’s local trust, foundation

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[819] *Code des impôts sur les revenus* 1992 art 2, 1 14.
[820] Appermont & Peeters (2019) *Trusts & Trustees* 5.
[821] N Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* (2017) 1029.
[822] Couturier, Peeters & Van der Velde *Belgisch Belastingrecht in Hoofdlijnen*.
[823] Appermont et al *De Kaaimantaks: Panta Rhei* 121.
[824] 121.

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or company law.[825] To this extent, it is submitted that the articles of association of the legal arrangement should be analysed to determine who appears as the founder. In practice, it is not necessarily the person who enjoys the benefits of the legal arrangement, who is expressly mentioned in the deed of incorporation.[826] In line with this reasoning, it is submitted that it is possible that an intermediary can also be regarded as a founder in terms of this definition. Furthermore, it may be the case that no deed of incorporation is required for the creation of a legal arrangement. In that case, no party can be designated as founder within the meaning of this first definition.[827]

Based on initial documents, it is possible that the legislator's objective was that the taxpayer at whose request the legal arrangement is set up, or the creator, must always be regarded as a founder within the meaning of the first category.[828] However, if anyone that is involved in the legal relationships from which the construction originates is considered to be a founder, it will mean that a number of possible intermediaries who will not ultimately enjoy the benefit of the income from the legal construction will also qualify as a founder. It is submitted that such an overly wide interpretation is in contrast with the purpose of the Cayman tax regime and cannot be correct.

In light of the above discussion, it is submitted that the Belgium company law meaning of founder should be adopted. In terms of this more restrictive interpretation, those who appear at the deed of incorporation, whether or not pursuant to a power of attorney or endorsement, are then to be considered incorporators under the first category of a founder. Such an interpretation is broad enough to include minority shareholders.

Aside from the aforementioned, the definition contains an important caveat. Only if the legal arrangement is established outside the exercise of the person's professional activity will said person constitute a founder.[829] With the inclusion of this limitation, it excludes most intermediaries from the ambit, which may play a role in the

[825] Goyvaerts (2015) *TFR* 869.
[826] Appermont (2015) *AFT* 21.
[827] V de Brauwere & C Wils "Taxe Caiman: le crocodile aux dents longues" (2015) 8 *RGF* 7.
[828] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[829] *Code des impôts sur les revenus* 1992 art 2, 1 14.

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formation of the legal arrangement, but will not derive any benefit from said arrangement.

5 4 1 1 2 The contributor

While the first category of founders concerned the formation of legal constructs, the second category targets the situation where assets are contributed to existing legal arrangements, which were established by someone else. To this extent, the second category of founders can be defined as follows: where a third party has set up the structure, the natural person acting outside the scope of his professional activity, or the legal person subject to tax on legal persons, who has placed goods and rights therein.[830]

When confronted with the second category, one immediately notes the restrictive nature of the definition. Before anything else, the definition limits the ambit to legal arrangements that were created by third parties. Hence, the contributor, who already qualifies as a founder in the first category, falls outside the scope of this definition. However, the addition of another founder does not relinquish the original founder's status as founder.[831] Instead, it is possible that one legal arrangement can have several founders.

The objective of the second category is to prevent taxpayers from circumventing the application of the first category. In this way, the administration has a fall-back position with regard to taxpayers who remain outside the strict framework of the first category.[832] With the introduction of the second category of founders, the legislator thus wished to prevent taxpayers who transfer assets to a legal construction from not being regarded as founders.[833]

As with the first category, the natural person making the contribution is assumed to be acting outside the scope of said person's professional activity.[834] If this is not the case, the second category cannot be applicable.

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[830] R Barbaix & AL Verbeke *Kernbegrippen Familiaal Vermogensrecht* (2014) 107.
[831] Appermont et al *De Kaaimantaks: Panta Rhei* 121.
[832] *Code des impôts sur les revenus* 1992 art 2, 1 14.
[833] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[834] *Code des impôts sur les revenus* 1992 art 2, 1 14.

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As is the case with the first definition, this second definition can also be criticised. It adds a temporal component in order to become a founder after the creation of a legal construction, but does not offer a way out of the qualification as founder.[835]

In other words, the second definition allows one to become the founder of a legal construction that already exists by a subsequent transfer of goods and rights to said arrangement. The transfer can either occur at the time of the incorporation by the third party, or at a later point in time. However, a later exit was not foreseen. Thus, once a person is regarded as a founder in terms of this definition, said person will remain a founder until the legal arrangement is ultimately dissolved.[836]

Pertaining to the transfer, the definition further refers to goods and rights.[837] The use of the word "and" implies that both elements must be present before the definition can apply. To this extent, it is possible that this collective requirement is intended to limit the ambit of the definition. However, a right, as an intangible good, is only part of the wider category of goods.[838] Thus, if an asset is contributed to the legal arrangement, it may conversely be assumed that the right to said asset is also transferred, unless the contrary is evident.

One also encounters these terms in the definition of the type one legal arrangement, but in that context, it is used in the alternative.[839] Therefore, the question was raised whether this implies that the second category of founders is only applicable to type one legal arrangements.[840] However, it is submitted that the mere use of comparable terms cannot support such an inference being made. The Advance Tax Ruling Authority seemingly concurs with this view.[841]

Furthermore, it is not clear whether the transfer must contain an element of bounty or if transfers for consideration are also included.[842] It is submitted that based on the wording used, both situations may be valid, but it is not reasonably tenable to regard every transfer under an agreement for consideration as a transfer for the

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[835] Article 2, 1 14.
[836] N Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* (2018) 1029.
[837] *Code des impôts sur les revenu*s 1992 art 2, 1 14.
[838] Verstraete & Migalksi (2015) *VIP* 4-15.
[839] *Code des impôts sur les revenus* 1992 art 2, 1 13a.
[840] Goyvaerts (2015) *TFR* 867.
[841] Preliminary Decision No 2016.602 of 29 November 2016.
[842] Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* 1029.

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purposes of this definition. If such an interpretation is followed, it will also include arms-length transactions. Hence, it is submitted that a restrictive meaning should be followed, which limits the inclusion of transactions for consideration to connected parties.

It is further submitted that the value of the contribution is irrelevant for purposes of the definition. Thus, regardless of the size of the contribution, the contributor can be regarded as the founder of the legal arrangement to which the transfer is made.

5 4 1 1 3 The heir

Unlike the previous categories of founders that required a positive action to be performed, the third category of founders is determined merely by the relationship to the original founder of the legal arrangement.[843] More specifically, the provision assigns the status of founder to the heirs of the founder of that legal arrangement. Thus, the third category of founders can be defined as either the natural persons who are directly or indirectly heirs of the persons referred to in the previous subsections or the natural persons who, upon death, will directly or indirectly inherit from such persons unless such heirs demonstrate that neither they nor their heirs will at any time or in any way obtain any advantage granted by the legal arrangement.[844]

Presumably, the aim of the third category is to ensure the continuation of the taxation on the income that is derived by a legal arrangement, even after the death of the founder. With the introduction of the third category of founders, the legislator has significantly widened the ambit of the Cayman tax regime.[845] This means that the operation of said regime is not limited to those founders that actively used legal arrangements, but also extends to the descendants of said founders.

However, not all founders are targeted. Instead, the provision only applies to founders under the first and second categories.[846] Hence, the heirs of founders, in accordance with the fourth or fifth categories, fall outside the definition's scope.

The only prerequisite for the definition to apply is a person to be designated as founder under one of the prior categories.[847] Thus, there is no requirement that said

[843] Goyvaerts (2018) *TFR* 644.
[844] *Code des impôts sur les revenus* 1992 art 2, 1 14.
[845] Appermont & Peeters (2019) *Trusts & Trustees.*
[846] Goyvaerts (2019) *Trusts & Trustees* 205.
[847] *Code des impôts sur les revenus* 1992 art 2, 1 14.

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founder must have had an actual liability to income tax.[848] This means that said founders' heirs will constitute founders under the third definition, regardless of whether any tax charge was ever due by virtue of the Cayman tax.

As with the foregoing categories, once one qualifies as a founder, the status of founder cannot be terminated. However, since one can become a founder without actively acting, in this case, it is logical that provision is made for a rebuttal. To this extent, if one proves that one will never obtain any benefit from the legal construction, one can escape the status of founder-heir.[849]

A taxpayer only becomes a founder's heir once said taxpayer's predecessor in title has died. For the purposes of applying the Cayman tax, this presupposes that the heir assumes the status of founder's heir only after the death of the founder within the meaning of the first or second category, or from the death of a decedent who himself became a founder's heir by inheritance. The Advance Tax Ruling Authority also follows this approach.[850]

Based on the wording used, it can be inferred that the third definition of founders refers to both heirs and beneficiaries. In other words, all natural persons with an interest in the original founder's estate, regardless of whether they are heirs with reserved portions, general legatees or special legatees, are included in the ambit.[851]

Presumably, the term heir was used by the legislator to include all successive heirs as founder's heirs, irrespective of any restrictions that may be imposed before said beneficiaries can benefit from the legal arrangement.[852] Hence, the connecting factor for the status of founder's heir is the death of the testator and not the future entitlement that an heir may have in the legal construction.

Aside from the above, the subdivision of the rights in the estate has no impact on the application of the definition.[853] In other words, the definition makes no distinction between heirs with different types of rights in the estate. To this extent, both the usufructuary and the bare owner will be considered founder-heirs.

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[848] Appermont et al *De Kaaimantaks: Panta Rhei* 107.

[849] Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* 1029.

[850] Appermont & Peeters (2019) *Trusts & Trustees* 5.

[851] Draye & Nijs (2016) *Trusts & Trustees* 508-515.

[852] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

[853] Appermont et al *De Kaaimantaks: Panta Rhei* 157.

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It follows that the definition is only applicable if a taxpayer accepts the inheritance. No one can be forced to become an owner, nor can one be forced to accept an inheritance.[854] This line of reasoning applies not only to those who are called to the inheritance based on legal devolution but also to those who are called to the inheritance by will or by agreement on succession.[855] Therefore, death does not automatically imply that the legal successors of the decedent also become owners of the estate assets. Instead, one only receives a right to these assets. The heir who rejects the inheritance will be deemed never to have been an heir, provided that the entire inheritance is rejected.[856] He will then also not be an heir for the application of the Cayman tax, and thus, cannot be considered a founder under this definition. However, by rejecting the inheritance, it does not affect the heir's ability to benefit from the legal arrangement.[857]

It is submitted that the introduction of a category of founder's heir, linked to the succession, is in itself understandable. After all, one can assume that in a general sense, the heirs of the initial founder will usually continue said founder's role in a legal construction. Moreover, it is likely that the heirs will also be the beneficiaries of the legal arrangement. Thus, designating said heirs as founders meet the overall objective of the Cayman tax regime to avoid taxing income only when it is actually attributed to the beneficiaries.[858]

However, if one can prove that neither oneself nor one's other future heirs will ever benefit in any way from the legal construction, one can escape the qualification of founder's heir, while still being able to accept the inheritance. Undeniably, this amounts to a very difficult burden of proof. Hence, it is submitted, for the heir to discharge the onus, it means that an heir must provide proof of a situation beyond his control. After all, the grant of an advantage may take place beyond the control of the beneficiary or even outside his knowledge.[859]

In light of the above, it is unclear how an heir is supposed to prove that he will never obtain any benefit from the legal arrangement. To this extent, the personal income tax return presupposes that the founder's heir discloses the existence of the

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[854] Appermont & Peeters (2019) *Trusts & Trustees.*
[855] Barbaix & Verbeke *Kernbegrippen Familiaal Vermogensrecht* 110.
[856] Verstraete & Migalksi (2015) *VIP* 14.
[857] Appermont (2015) *AFT* 21.
[858] Goyvaerts (2016) *JoIT&CP* 27.
[859] Afschrift (2016) *JDF* 65-112.

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legal arrangement.[860] However, is it sufficient for a taxable heir to consider that he can prove that he will never obtain any advantage, or must this be demonstrated? Based on the wording used, it seems that the definition requires the provision of concrete proof. This implies that the heir will have to provide documentary evidence. It is submitted that the level of proof required renders the exception virtually useless, and thus, unworkable.

5 4 1 1 4 The holder of rights

The fourth category of founders further expands the group of persons that can be designated as founders to include not only those who created a legal arrangement,[861] or contributed assets to an existing legal arrangements, or inherited from one of these founders but also if one holds part of the legal or economic rights of the arrangement.[862] It follows that the fourth category can be defined as the natural or legal persons subject to the tax on legal persons who hold the legal rights to the shares or the economic rights to the property and capital in possession of a type two legal arrangement.[863]

It is plausible that the fourth category was introduced to prevent taxpayers from circumventing the application of the prior categories by acquiring shares in the legal arrangement. With the addition of the fourth definition, the legislator managed to expand the already wide ambit to cover virtually any situation.[864]

Unlike the previous definitions, the fourth definition not only indicates how one becomes a founder, but also implicitly explains when one is not considered a founder.[865] Accordingly, only at the time of holding the rights will one be considered a founder under this category. Notwithstanding the aforesaid, this definition is by no means perfect. Instead, it is full of ambiguous terms, which are not defined, nor explained.

[860] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[861] *Code des impôts sur les revenus* 1992 art 2, 1 14.
[862] Article 2, 1 14 and 1 13a.
[863] *Code des impôts sur les revenus* 1992 art 2, 1 14.
[864] Goyvaerts (2018) *TFR* 647.
[865] Goyvaerts (2019) *Trusts & Trustees* 213.

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However, the fourth category of founders is only limited to type two legal arrangements.[866] Considering the nature of type one arrangements,[867] it is understandable that such arrangements were excluded from this definition. Thus, this category has a strict application.

When confronted with the definition, it is apparent that two groups of persons are targeted. Firstly, those taxpayers who hold the legal rights to the shares, and second, those persons who hold the economic rights to the property and capital of the legal arrangement.[868]

Despite the wording used, it is submitted that the definition does not only apply if all the shares or all the property and capital are held by a party. Instead, it is sufficient that a portion of the shares or part of the property and capital is held.

As alluded to, neither the term legal rights, nor economic rights are defined. Based on the context, one can infer that the terms are used collectively to broaden the ambit of the definition, but within the confounds of the type two category.[869] To this extent, it is likely that a division of rights will also be covered by the definition. Furthermore, it has been suggested that the term shares may also extend to certifications,[870] but such reading appears to be inconsistent with the purpose. Similarly, it has been suggested that the notion of economic rights can possibly be equated with beneficiaries' interest, but such an interpretation seems undesirable. Thus, it is submitted that a more restrictive interpretation is to be preferred. However, since this category of founders is limited to type two legal arrangements, the aforesaid will not be further discussed.

5 4 1 1 5 The contractor

Finally, the fifth category of founders targets the contracting party of a type three legal arrangement. To this extent, the fifth category can be defined as follows: the natural or legal person subject to tax on legal persons, who has concluded the contract, and in whose name the premium or premiums of this contract are paid.[871]

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[866] *Code des impôts sur les revenus* 1992 art 2, 1 13b.
[867] Article 2, 1 13a.
[868] Article 2, 1 14.
[869] Article 2, 1 13b.
[870] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[871] *Code des impôts sur les revenus* 1992 art 2, 1 13b.

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This last founder definition was added in connection with the type 3 legal arrangement, which was introduced in subsequent amendments to the Cayman tax regime.[872] This legal arrangement is described as a special type of agreement and usually takes the form of a qualifying legal arrangement that is modified in such a way as to avoid the scope of the Cayman tax. Typically, such an arrangement will be a contract with an underlying legal construct.[873]

Due to the specific link with the type three legal arrangement, it can be argued that this capacity should be interpreted restrictively. Hence, a taxpayer will only qualify as a founder-contractor under this definition if it involves a type three legal arrangement.[874]

It appears that the definition contemplates two possibilities of founders. First, it targets the signatory of the contract, and second, it extends to the principal beneficiary of the agreement.[875] Presumably, in most cases, these will be one and the same person, but it is quite possible that these roles are fulfilled by two different persons.

Furthermore, the definition refers to the payment of a premium for the contract.[876] Although the majority of type three legal arrangements may be structured in such a way that there is a premium payable, the third category of arrangements also extends to arrangements without any consideration.[877]

Following from the above, it is unclear whether the reference to premium should be understood as a prerequisite for application. In other words, is the definition limited to those type three arrangements where a premium is payable.

Considering the purpose of this definition, it is submitted that it is unlikely that such an interpretation can be correct. If such reasoning is followed, it would mean that those type three legal arrangements that do not involve premiums will fall outside the scope of the Cayman tax regime, which is in contrast with the objective of the definition. However, a legislative amendment is recommended to provide for such interpretation explicitly.

[872] Appermont & Peeters (2019) *Trusts & Trustees* 5.
[873] Appermont et al *De Kaaimantaks: Panta Rhei* 125.
[874] *Code des impôts sur les revenus* 1992 art 2, 1 13c.
[875] Article 2, 1 14.
[876] Article 2, 1 14.
[877] Article 2, 1 13c.

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5 4 1 2 Qualifying legal constructs

Despite various justifications and an unclear overall objective, a certain constant thread has existed since the introduction of the Cayman tax. Based on the explanatory memorandums, it is clear that the overarching purpose was to neutralise the perceived tax advantages associated with the use of legal arrangements.[878] It was considered that the use of such arrangements operates in a tax vacuum, enabling tax avoidance. Hence, the Cayman tax regime was designed to create the possibility of taxation in situations where normal taxation would otherwise have been circumvented.[879]

Although the operation of the Cayman tax disregards the existence of the legal arrangement, it is evident that the Cayman tax does not completely negate the arrangement in its entirety.[880] Indeed, in the light of the Cayman tax, it is only the income from these legal arrangements that will be taxed, if any, under a regime of fiscal transparency.[881] Thus, the legal acts of the legal arrangements will not be ignored under civil or company law.

It follows that the acts performed by a legal arrangement remain relevant not only in the greater legal system, but also for the tax classification of the income received by said arrangement.[882] Furthermore, the distribution by a legal arrangement is also separately assessed for tax purposes.[883] This further provides credence to the notion that the Cayman tax does not overlook the legal arrangements as such.

Ultimately, every form of asset structuring has legal consequences, which change the taxation. For this reason, it is necessary to define which legal arrangements are precisely targeted. Thus, without further definition, almost any form of asset structuring could constitute a legal construction to which the Cayman tax could be applied.

In defining the different types of legal arrangements, the notion of legal personality is largely used.[884] Thus, in broad terms, type one legal arrangements cover entities without separate legal personality. Conversely, type two legal arrangements

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[878] Appermont Appermont (2014) *Trusts & Trustees* 232.
[879] Appermont (2015) *AFT* 26.
[880] 26.
[881] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[882] Goyvaerts Goyvaerts (2019) *Trusts & Trustees* 217.
[883] Appermont & Peeters (2019) *Trusts & Trustees* 6.
[884] Goyvaerts (2016) *JoIT&CP* 31.

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encapsulate those entities with legal personality.[885] However, both the type one and type two categories have specific requirements that need to be satisfied.[886] Hence, not all entities without legal personality will automatically constitute a type one legal arrangement, nor will those with legal personality, by default be regarded as type two legal arrangements.

The use of "legal personality" as a dividing line between type 1 and type 2 legal arrangements is, however, less clear than it may appear at first sight and cannot always justify the differences in treatment in a pertinent manner.[887]

The distinction made between legal relationships and legal persons is not only vague but also not always appropriate.[888] Both tax law and common-law struggle with the precise delineation of the concept of "legal personality". Neither in tax law nor in common law is there a clear, unambiguous definition.[889] The granting of legal personality under Belgian law is mainly solved internally by granting legal personality nominally to certain legal forms.[890] In this case, however, this difficult-to-define concept of legal personality must be applied for tax purposes to foreign legal forms.

In addition to the above, the ambit of the regime was subsequently expanded with the introduction of a further category of qualifying legal arrangements.[891] However, this third category departed from the link to legal personality. Instead, the so-called type three legal arrangement relates to special agreements, by which one of the previous legal constructions is "wrapped up" in an additional agreement. Thus, it appears that this third category functions as a catch-all provision. After all, the explanatory memorandum assumes that certain forms of "packaging" would preclude the application of the Cayman tax regime.[892]

By subjecting various legal arrangements to the same valuation regime, it becomes clear that the Cayman tax system was intended to cover very different situations under the same rule. In the first place, a solution is sought for assets that

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[885] *Code des impôts sur les revenus* 1992 art 2, 1 13b.
[886] Goyvaerts (2018) *TFR* 644.
[887] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[888] Verstraete & Migalksi (2015) *VIP* 9.
[889] 7.
[890] Couturier, Peeters & Van der Velde *Belgisch Belastingrecht in Hoofdlijnen*.
[891] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[892] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

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are, as it were, separated from the taxable person for whom they are managed.[893] In many systems, such a carved-out asset will not be taxed, and the ultimate recipient will enjoy the acquired income tax free.[894] Second, as a typical form of CFC legislation, it reacts against the use of low-tax, controlled companies on the basis of which a tax deferral can be achieved.[895] Finally, in extension to this second category, the income of inverted hybrid entities is also integrated.

Despite the introduction of definitions, the last few years have shown that it is not easy to enumerate the various legal forms that fall within the scope of these three types of legal arrangements.[896]

However, the general, vague wording of the various forms of legal constructions prompted the legislator to make provision for a number of exceptions. To this extent, regulations were subsequently published that specifically states which legal arrangements are excluded from the regime. Regardless of the fact, that such arrangements may satisfy the criteria.[897]

For the first time, the Cayman tax introduced a generalised taxation regime for low-taxed foreign legal arrangements.[898] But apart from this special regime, the administration could already beforehand make use of other possibilities to include income in the Belgian income tax.[899]

For one, reference can be made to the general tax transparency of a legal arrangement without legal personality.[900] To this extent, it can be inferred that legal forms without legal personality that do not meet the definition of a legal construction type 1 will be caught by this transparency. Moreover, the tax administration has various special and general anti-abuse provisions available that can be invoked to include income in the Belgian tax sphere. Furthermore, simulation was also previously used in relation to some of the legal arrangements targeted by the Cayman tax. In addition, the administration sometimes argues that foreign legal entities are, in fact,

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[893] Goyvaerts (2016) *JoIT&CP* 27.
[894] Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* 1049.
[895] Lust (2018) *Trusts & Trustees* 230-237.
[896] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[897] Royal Decree of 23 August 2015; Royal Decree of 21 November 2018; Royal Decree of 6 May 2019.
[898] Lust (2018) *Trusts & Trustees* 230-237.
[899] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[900] Afschrift (2016) *JDF* 5-45.

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managed from Belgium and are, therefore, directly subject to Belgian income tax because of their legal domicile in Belgium.[901] In such a case, there will also be legal entities whose income is subject to Belgian income tax as soon as the subject receives this income.

Notwithstanding the above, it is clear that the legislator did not even consider the difficult connection of the Cayman tax with these other regimes. Nevertheless, one should be aware that these regimes were not abolished by the Cayman tax either.[902] However, an in-depth discussion of the aforesaid falls outside the ambit of this dissertation.

However, the focus will now shift to a discussion of the definitions of the three different types of legal arrangements.

5 4 1 2 1 Type one legal arrangement

As alluded to above, the type one legal arrangement primarily applies to legal entities without separate legal personality. However, the definition further introduces a number of specific characteristics that must be present before said entity can be classified as a type one arrangement. It follows that the type one category can be defined as: a legal relationship created by a legal act of the founder or by a judicial decision, whereby goods or rights are brought under the control of an administrator in order to administer them for the benefit of one or more beneficiaries or for a specific goal.[903]

Such legal relationship has the following characteristics:

1. the title to the property or rights of the legal structure has been drawn up in the name of an administrator or in the name of another person on behalf of the administrator;
2. the assets of the legal construction constitute separate assets and are not part of the assets of the manager;
3. the manager has the power and the duty, for which he is responsible, to administer and to manage the assets of the legal arrangement in accordance

[901] A Tiberghien *Handbook voorfiscaal recht 2016 – 2017* (2017).
[902] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[903] *Code des impôts sur les revenus* 1992 art 2, 1 13a.

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> with the provisions of the legal arrangement and the special obligations to which it is subject by law.[904]

Based on the explanatory memorandums, it can be deduced that the definition of a trust in article 122 of The International Private Law Act of 16 July 2004 ("IPLA") inspired the definition of a type one legal arrangement.[905] However, the final scope was adapted by using more generalised terminology. Thus, it can be assumed that by no longer referring to the strict terms of "trustee" and "trust", a broader scope applies to the definition used for the application of the Cayman tax, than in the context of the IPLA. However, the exact demarcation is unknown.

The strong resemblance to the definition of a trust is not, however, completely surprising. Throughout the preparatory works and accompanying documentation, the trust has explicitly been referred to.[906] Unfortunately, all such statements illustrate the pre-conceived perceptions and scepticism of trusts. The mistrust of the trust concept in general, is regrettable. After all, it is generally a useful form of asset structuring for many perfectly legitimate purposes.[907] Nevertheless, this obsession with trusts meant that said definition was used as the point of departure for type one arrangements, but the legislator wanted to ensure that the wording used was flexible enough to make provision for future developments and not limit the application to only trusts.

Thus, the "trust" remains unmistakably the most important type 1 legal arrangement, but due to the wide ambit of the type one definition, other arrangements may also be caught.[908] This means that it is possible that other fiduciary relationships can also constitute a type one legal arrangement and hence, be subject to the Cayman tax regime.

Although it is clear that trusts are targeted, it is less clear how the Cayman tax relates to the classic assessment method for trusts.[909] Are two coexisting valuation regimes created, or should the previous assessment be considered obsolete?

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904 Article 2, 1 13a.

905 Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

906 Appermont et al *De Kaaimantaks: Panta Rhei* 119.

907 Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* 1029.

908 Lust (2018) *Trusts & Trustees* 230-237.

909 GD Goyvaerts "The Tax Aspects of the Use of Foreign Trusts in Belgium for Private Wealth Purposes" (2011) 18 *Journal of International Tax, Trust and Corporate Planning* 267.

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On the one hand, the acquisition of income by a trust is taxed on the founder, while on the other hand, the same income could also be qualified as interest and taxed by the beneficiary if the beneficiary has a right of action.[910]

A partial solution could be to make the Cayman tax regime applicable only to beneficiaries of a discretionary trust. After all, it is only in this context that a tax assessment on the part of the beneficiaries was not previously possible. Thus, in a fixed-interest trust, income from the beneficiary would be taxed as interest, and the Cayman tax would provide a solution for untaxed income.

While the Cayman tax legislation and explanatory memorandums are full of ambiguity, if one considers the holistic regime, it is unlikely that such an interpretation was intended. Instead, it is more probable that the legislator merely overlooked the interaction of the regimes. Hence, it is submitted that the Cayman tax regime applies equally to both discretionary and fixed-interest trusts. It is further submitted that the Cayman tax regime forms the default system for taxing trusts in Belgium. In the instance that the Cayman tax regime does not apply, the classic assessment model may be invoked to tax the income received by said trust. But it is submitted that such a scenario would be an exception.

Aside from trusts, other arrangements may also be encapsulated under the definition.[911] The question then is which other entities, aside from the trust, can fall within the scope of the definition. It is plausible that the intention was also to include other fiduciary relationships. However, a fiduciary relationship is rather an umbrella term for various legal entities with similar characteristics but with legally distinct working methods.[912] Hence, the use of said term does not provide any clarity.

However, even if the legislator wanted to define the type one category as broadly as possible, a set definition has been provided. The use of a vaguer, generalised standard may possibly accommodate certain situations with which one wants to approach the creation of a trust as closely as possible through other legal forms. But, the legal definition remains specific so that for each legal form a strict assessment must be undertaken to determine whether or not said entity is covered by the definition.[913] If all the characteristics are not present, but there is a tax avoidance

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[910] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[911] Appermont & Peeters (2019) *Trusts & Trustees* 6.
[912] 6.
[913] Goyvaerts (2015) *TFR* 867.

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objective, it may be possible to make use of the general anti-avoidance provisions, although the structure may not qualify as a type one legal arrangement.[914]

Moreover, the importance of a precise definition of the type one legal construction was reinforced by two different factors: First, the Advance Tax Ruling Authority has shown that it interprets the definition broadly and, thus, brings certain forms of asset structuring under the ambit of the Cayman tax. For example, it has been held that the combination of a foundation office with a civil partnership constitutes a type one arrangement,[915] while the definition was also applied in the fight against double structures[916] prior to the legislative amendments made in 2017. Second, distributions by type one arrangements are now also deemed to be a dividend as of the changes made to the Cayman tax system in 2017, and hence, taxed accordingly.[917] Previously, the reserves of type one arrangements remained untaxed until a taxable event occurred. However, this may now change with the deemed dividend rules. Thus, a precise delineation of all type one legal arrangements is even more paramount.

In light of the above, for there to be a type one legal arrangement, there must be an administrator who is the owner of goods/rights or on whose behalf the goods/rights are administered in the name of another person. Although he owns said goods/rights, these goods/rights remain separate from the broader assets of the manager and hence, do not form part of said manager’s personal estate. The manager's powers and duties over these assets are further regulated in special legal obligations or in the agreement establishing the legal arrangement. Thus, the manager is obliged to account for said assets.

It follows that if these conditions are not met, there is no type one legal arrangement. Therefore, an overly broad approach would reduce any form of asset structuring, whereby property is placed under the control of a manager for the benefit of beneficiaries, to a type 1 legal arrangement. Thus, it can be assumed that the definition is intended to only apply to specific forms of asset structuring. In particular,

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[914] Appermont (2015) *AFT* 21.

[915] Preliminary Decision No 2015.538 of 22 December 2015; Preliminary Decision No 2016.613 of 18 October 2016.

[916] Preliminary Decision No 2016.564 of 22 November 2016; Preliminary Decision No 2016.610 of 22 November 2016; Preliminary Decision No 2016.576 of 29 November 2016.

[917] *Code des impôts sur les revenus* 1992 art 18, para 1 3.

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the regime was intended to assess those arrangements whose operation, without the Cayman's tax, could otherwise lead to a tax void.[918]

Although a detailed examination of asset structures falls outside the ambit of this dissertation, the following discussion will briefly touch on some forms of fiduciary relationships that exist in Belgian law, as well as some better-known foreign legal forms, in light of the definition of a type one arrangement. The view of the Advance Tax Ruling Authority, as expressed in some special rulings are also mentioned.

Over the years, various studies have examined how Belgian private law figures could possibly approach the characteristics of a trust.[919] But given the Belgian *numerus clausus* principle of rights *in rem* and the principle of indivisibility of property, the introduction of the trust as such in Belgium is not self-evident.[920] It may be true that so-called fiduciary legal relationships are distinguished that resemble a trust, but such arrangements do not coincide with the trust. As a functional equivalent, reference is also made to forms of indirect representation, whereby the person who is represented remains the owner of the goods to which the power of representation relates. The real fiduciary would imply that the managing fiduciary also becomes the owner on behalf of the transferor.

While numerous fiduciary relationships exist, it is probable that the definition should only extend to those fiduciary forms which are most in line with the asset structuring that the legislator intended to target with the Cayman tax regime.[921]

An important first question is whether an entity with legal personality itself can be considered a type one legal arrangement. After all, it was indicated earlier that a distinction between the two legal constructions is made on the basis of legal personality.[922] However, the definition of a type one legal relationship is drafted in rather general terms, and legal persons are not explicitly excluded. Hence, the fact that only entities with legal personality are targeted under type two does not automatically exclude the possibility that legal persons themselves could also fall under the type one category, provided that the conditions are fulfilled.

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[918] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[919] Appermont (2015) *AFT* 21.
[920] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[921] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[922] Goyvaerts (2015) *TFR* 867.

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It is submitted that the type one legal arrangement is limited to entities without legal personality. The aforesaid becomes evident if one carefully tests the characteristics of the definition.[923]

If assets are contributed to a legal person, the title to said assets will, in principle, be in the name of this legal person.[924] The assets may subsequently be managed by a director, but the assets are not the property of the director of the legal person. After all, the legal person itself is the owner of the segregated assets.

If one considers the first requirement, even if one interprets the term manager to also refer to the legal construction itself, the other conditions of the definition are not fulfilled. The legal person is then only the owner of one asset. The assets will not constitute a separate asset for the legal person, resulting in the second requirement not being satisfied.

In view of the foregoing considerations, a Belgian private foundation, for example, cannot be considered a type one legal arrangement. This is a legal entity under Belgian law: it acquires legal personality from the moment that its articles of association and the deeds relating to the appointment of the directors are filed with the registry of the commercial court.[925] Thus, the Belgian private foundation is the owner of its assets, and the legal title is in its name, not that of its board of directors. The Advance Tax Ruling Authority confirmed this view.[926]

The same conclusion can be reached for the certification of securities. As the certification is mostly done through a legal person, the conditions for a type one legal arrangement will not be fulfilled. After all, the title to the certified assets will be in the name of the issuer, and the goods do not constitute separate property for this owner. This is also in line with the advance ruling service.[927] However, a certified partnership was excluded.[928]

However, the question arises whether unincorporated investment funds can qualify as type one legal arrangements. In this respect, it must be verified whether they meet the conditions of the definition. More specifically, it will have to be verified

[923] *Code des impôts sur les revenus* 1992 art 2, 1 13a.
[924] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[925] M Ex, AL Verbeke, B Verdickt "The Belgian private foundation" (2021) 27 *Trusts & Trustees* 479.
[926] Preliminary Decision No 2014.543 of 9 December 2014.
[927] Preliminary Decision No 2016.602 of 29 November 2016.
[928] Preliminary Decision No 2017.132 of 4 April 2017.

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whether the title to the contributed assets or capital has been established in the name of the manager or in the name of another person on behalf of a manager.

Based on the explanatory memorandums, it is explicitly confirmed that investment funds without legal personality in which the holders of parts of the funds own the assets invested indivisibly are not type one legal arrangements.[929]

According to the Minister of Finance, the non-application of the look-through tax to such investment funds is deliberate, as these funds are already treated transparently from a tax point of view.[930] Hence, it does not make sense to subject these funds to the Cayman tax regime.

In terms of income tax, it is generally assumed that a (civil) partnership in the sphere of private wealth planning, due to the lack of legal personality, is tax transparent.[931] Nevertheless, this does not exclude that a partnership could qualify as a type one legal arrangement. After all, the Cayman tax hardly takes into account other possibilities whereby income is already taxed on Belgian taxpayers. Therefore, the partnership must also be tested against the precise conditions of the definition.

In a first quick reading, it could be established that the partnership does not qualify as a type one legal arrangement because the property contributed to the partnership is not in the name of the partnership. If "the partnership" is considered to be the "manager", then it has no title of ownership. However, goods can also be in the name of another person on behalf of the manager. If a partner, who also acts as a manager of the company, owns the goods, the conditions of the definition do seem to be met. After all, the capacity of partner and manager then coincide.

Thus, neither the certification nor the partnership in itself is considered a type one legal construct.[932] Nevertheless, the Advance Tax Ruling Authority decided in some remarkable preliminary rulings that the combination of both techniques in its entirety is to be considered a type one legal construction.[933] Equally remarkable is that the Advance Tax Ruling Authority did not address the issue further.

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[929] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

[930] Appermont et al *De Kaaimantaks: Panta Rhei* 119.

[931] J-M Tirard "The Global Guide to Trusts" <https://www.academyfinance.ch/books/ggt.pdf> (accessed 2022-05-21).

[932] Preliminary Decision No 2017.132 of 4 April 2017; Preliminary Decision No 2016.602 of 29 November 2016.

[933] Preliminary Decision No 2015.538 of 22 December 2015; Preliminary Decision No 2016.613 of 18 October 2016.

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In essence, the rationale of the Ruling Authority in both rulings seems to be based on two considerations. On the one hand, based on a functional analysis, the Ruling Department seems to be of the opinion that the *Stichting Administratiekantoor* ("STAK") can be regarded as a type 1 legal construction because through the operation of the "dual structure", a kind of "special-purpose asset" is created with legal consequences similar to those of a trust.[934] It is acknowledged that there is no question of a trust, but it is stated that there is nevertheless a strong resemblance to a trust-like structure without this actually being invoked. It is only afterwards, in a rather teleological manner, that it is assessed whether this structure meets the conditions of a type 1 legal construction as defined by law. The Preliminary Decisions Department points out that the combination of STAK-BM would result in the Belgian withholding tax being unfairly withheld.[935] This argument also seems to be aimed rather at avoiding a tax vacuum, in the light of which the setup structure should then be interpreted.

Furthermore, whether or not there is a resemblance to a trust-like structure is irrelevant. What is exclusively important to qualify as a type one legal arrangement is the wording of the definition.[936] Only if all characteristics mentioned therein occur, is there a type one legal arrangement. Therefore, as a tax provision, the definition may not be interpreted teleologically. On the contrary, a pure and strict reading of the conditions mentioned is required.

Moreover, this raises the question of whether the combination of various legal figures can be broadly reduced to a single "unified" legal construct. After all, in its rulings, the Advance Tax Ruling Service states that the sum of a STAK and partnership leads to a type one legal construct whereby the relevant features are jointly sought within each of the two legal figures.[937] This analysis differs from what is now known in doctrine as a "dual structure" and in law under the chain constructions.[938]

Such construction normally refers to the superimposition of various legal arrangements, as a result of which the founder (or beneficiary) of one specific legal arrangement would no longer be qualified as the founder (or beneficiary) of the

[934] Preliminary Decision No 2014.319 of 19 August 2014.
[935] Preliminary Decision No 600.439 of 19 December 2006.
[936] *Code des impôts sur les revenus* 1992 art 2, 1 13a
[937] Preliminary Decision No 2017.132 of 4 April 2017.
[938] Code des impôts sur les revenus 1992 art 2, 1 137/4.

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adjoining legal arrangement.[939] In this case, however, the various legal entities do not in themselves qualify as legal arrangements. The Preliminary Ruling Service also explicitly confirms that already the STAK cannot be qualified as a legal arrangement.[940] No such explicit position is taken with regard to the partnership, but it was indicated above that the partnership does not constitute a type one arrangement.[941]

Although the definition explicitly speaks of a legal relationship in the singular, the Advance Tax Ruling Authority nevertheless takes two legal relationships together in order to qualify the whole as one legal construction.[942]

In light of the above, it is submitted that the decisions by the advance ruling service adopt a form of a holistic approach for evaluating a combination of legal arrangements. It is further submitted that such an approach is in contrast with the actual wording of the definition. However, it can be inferred that the rationale is rather to fulfil the objective of the Cayman tax rather than adhere to the legal prescripts. Notwithstanding, it is submitted that such an interpretation is wrong in law and cannot be supported.

In addition to the Belgian legal figures, other legal figures can also be found outside Belgium that could qualify as a type one legal arrangement. The lack of an exhaustive overview means that each individual legal structure can be tested against the precise conditions in the definition. To this extent, it is submitted that both the French fiduciary agreement and the Luxembourg fiduciary contract comply with the definition of a type one legal arrangement.[943] Hence, such arrangements will constitute type one arrangements and will thus be subject to the Cayman tax regime. However, these arrangements are already treated transparently for tax purposes,[944] so it is unclear what will be achieved by also subjecting said arrangements to the Cayman tax regime.

[939] F Debelva, AM Vanderkerkhove & G Verachtert "Ontsnappen dubbelstructuren steeds aan de kaaimantaks?" (2016) 30 *Fisc Act* 3-7.
[940] Preliminary Decision No 600.439 of 19 December 2006.
[941] Preliminary Decision No 2015.538 of 22 December 2015; Preliminary Decision No 2016.613 of 18 October 2016.
[942] Preliminary Decision No 2014.319 of 19 August 2014.
[943] Appermont et al *De Kaaimantaks: Panta Rhei* 119.
[944] Preliminary Decision No 600.092 of 27 February 2006.

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From the above analysis it can be concluded that the type one definition cannot be used to designate all kinds of "legal relationships" as type 1 legal constructions. Unfortunately, the legislator devoted little thought to the analysis of this legal definition. First of all, it is clear that trusts are pre-eminently a type 1 legal construction. After all, the legislator chose to stick to the wording of the IPLA concerning the definition of trusts. However, it is important to note that trusts also need to have all the above characteristics. Although this will usually be the case, it is not necessarily always the case.

In addition, it should be noted that the legislator intended a wider interpretation.[945] To this extent, the impact of the definition on other Belgium and foreign legal relationships with a similar effect as the trust was briefly investigated. Thus, it is submitted that the conclusion must be that these legal relationships cannot be regarded as a type 1 legal arrangement, merely on the grounds of their comparable effect. It should always be verified whether the characteristics are fully present. Therefore, a (Belgian) private foundation or a mere (civil) partnership will not be considered as a type one legal arrangement. The position taken by the Advance Tax Ruling Authority on the "certified partnership" is also questionable in this respect and does not seem to fit in with the strict conditions of the definition.

5 4 1 2 2 Type two legal arrangement

While the type one legal arrangement mainly focuses on arrangements without separate legal personality, the type two category exclusively applies to legal persons.[946] (However, since the inception of the Cayman tax regime, the definition of the type two legal arrangement has undergone various amendments as the regime evolved, which resulted in a much wider ambit.)[947]

Thus, the type two legal arrangement can be defined as follows: any company, association, establishment, institution or entity which has legal personality and which, under the provisions of the law of the State or jurisdiction in which it is established, is either not subject to income tax or subject to income tax that amounts to less than

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945 Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
946 *Code des impôts sur les revenus* 1992 art 2, 1 13b.
947 Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

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15% of the taxable income of this legal arrangement, which is determined in accordance with the rules applicable to the establishment of Belgian tax on corresponding income.[948]

Based on the wording used, the type two definition has some clear differences compared to the other legal arrangements. First, as explained earlier, type two legal arrangements are distinguished from type one legal arrangements by the requirement of legal personality.[949] In this case, an explicit reference is made to such entities with legal personality. Hence, only legal persons can qualify as a type two legal arrangement. In addition, the definition includes a tax threshold of 15 %.[950] By virtue of this exception, entities subject to a tax threshold of at least 15 % are thus excluded by definition from this category, regardless of whether the other conditions are fulfilled. However, there are numerous uncertainties regarding the determination and application of this exception.[951] But, a further discussion of these aspects falls outside the ambit of this dissertation.

Unlike the type one category, the type two definition was accompanied by pre-determined lists of entities that qualify as type two arrangements, as well as those entities that are specifically excluded from the ambit of the definition.[952]

To determine which entities qualify as type two legal arrangements and those that are explicitly excluded, a distinction is made between entities within the European Economic Area ("EEA"),[953] and those entities that are located in jurisdictions outside the EEA.[954] These various lists were promulgated by royal decrees.

Pertaining to entities within the EEA, the published lists are considered to be exhaustive.[955] Hence, if an EEA entity is not mentioned in the EEA list, it cannot be called a type two legal construction.[956] This means that, in principle, taxpayers have no obstacle to using an arrangement or legal form established within the EEA, which is not mentioned in the list, even if said arrangement is subject to taxation below the

[948] *Code des impôts sur les revenus* 1992 art 2, 1 13b.
[949] Verstraete & Migalksi (2015) *VIP* 7.
[950] *Code des impôts sur les revenus* 1992 art 2, 1 13b.
[951] Appermont et al *De Kaaimantaks: Panta Rhei* 131.
[952] Royal Decree of 6 May 2019; Royal Decree of 21 November 2018; Royal Decree of 23 August 2015.
[953] Royal Decree of 21 November 2018.
[954] Royal Decree of 23 August 2015.
[955] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[956] *Code des impôts sur les revenus* 1992 art 2, 1 13b.

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threshold of 15% as stated in the definition. In such a case, this legal form is then not caught by the fiscal transparency of the Cayman tax.

The EEA comprises the 27 member states of the EU and includes Iceland, Liechtenstein and Norway.[957] Switzerland is currently not a member of the EEA. Swiss constructions will thus have to be assessed under the regular application conditions of the definition and the so-called non-EEA list.

By working with an exhaustive list, the government wanted to ensure conformity with EU and EEA law.[958] The possible obstacle to the freedom of establishment and the free movement of capital was thus reduced to what is considered necessary to stop existing tax claims.[959] The obstacle could thus be justified in the light of the avoidance of double non-taxation.

With regards to non-EEA entities, the provided list is not intended to be exhaustive.[960] Instead, said list is explicitly refutable. To this extent, the provision specifically mentions that the targeted entities are presumed to comply with the definition.[961] In other words, this is a refutable presumption that works in both directions. On the one hand, the administration can demonstrate that other legal forms are not contained on the list, but still meet the definition of a legal arrangement type two. The taxpayer can provide evidence to the contrary that a listed legal arrangement does not meet the described conditions.

It is submitted that type two legal arrangements can be described as legal persons whose income is insufficiently taxed according to Belgian standards. It is further submitted that within this category, the evolutionary character of the Cayman tax regime is especially striking. Both the legal definition and the implementing decrees have frequently been subject to retrospective amendments.[962] Moreover, the fight against perceived abuse and closing loopholes appears to be the primary motivation for the changes. Although foreign tax thresholds are taken into account, this is mainly used to define an insufficient level of taxation.[963] In light of the aforesaid, the

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957 European Union "Country Profiles" <https://european-union.europa.eu/principles-countries-history/country-profiles_en> (accessed 2022-05-25).
958 Lust (2018) *Trusts & Trustees* 230-237.
959 Appermont & Peeters (2008) *Fiscoloog* 5-8.
960 Royal Decree of 23 August 2015.
961 *Code des impôts sur les revenus* 1992 art 2, 1 13b.
962 Goyvaerts (2018) *TFR* 657.
963 Appermont et al *De Kaaimantaks: Panta Rhei* 131.

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successive amendments result in legal uncertainty, with the legislator failing to develop a conceptually coherent approach to the classification of the type two arrangements.

5 4 1 2 3 Type three legal arrangement

Unlike the foregoing categories, the type three legal arrangement breaks the link with the criteria of legal personality as a distinguishing factor.[964] Instead, the type three category aims to address the limitations of the previous categories. To this extent, the type three legal arrangement applies to contractual arrangements that subsume either type one or type two constructs in such a way as to fall outside the ambit of the Cayman tax regime.[965] Thus, said category can be described as an anti-avoidance provision.

It follows that the type three legal arrangement can be defined as:

> "any agreement whereby it provides:
>
> (1) in return for the payment of one or more premiums, during the term of the agreement or on its expiry, provides for the disbursement of the income obtained from a qualifying legal arrangement, or the distribution of the economic rights, shares or assets of said qualifying legal arrangement; or
>
> (2) in exchange for the contribution of the economic rights, shares or assets of a qualifying legal arrangement, provides for the payment or distribution of the contributed rights, shares or assets or their equivalent during the course of the contract or at the end of said contract."[966]

Hence, the type three definition envisages techniques whereby a type one or two legal arrangement is "wrapped up" in a further agreement to avoid the application of the Cayman tax.[967]

Thus, the type 3 legal arrangement stipulates two forms of contracts, regardless of the final beneficiary.[968] Either one or more premiums are paid in exchange for the payment of the income of a type one or two legal arrangement or the distribution of the economic rights, shares or assets of a type one or two legal arrangement. Or the economic rights, shares or assets of a type one or two legal arrangement are

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[964] Lust (2018) *Trusts & Trustees* 230-237.
[965] Goyvaerts (2019) *Trusts & Trustees* 213.
[966] *Code des impôts sur les revenus* 1992 art 2, 1 13c.
[967] Appermont et al *De Kaaimantaks: Panta Rhei* 131.
[968] Goyvaerts (2016) *JoIT&CP* 27.

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contributed in exchange for the distribution or payment of this contribution or its equivalent.

This means that by virtue of the type three arrangement, there is no longer any link between the person who concludes the contract and in whose name the premium is paid and the founder of the underlying legal arrangement. Inevitably this gives rise to various possible permutations. However, a detailed analysis of all potential variations falls outside the ambit of this dissertation and will not be further discussed.

Based on the wording used, the definition is formulated broadly. (309) Although the definition refers to the term agreement, it is not defined. However, the legislator likely intended the category's ambit to be limited to agreements of a purely contractual nature.[969] But, even with this demarcation in place, the definition will have a very wide reach, which means overlaps between the other categories are plausible, especially with the type one legal arrangement.

The first type of agreement requires the payment of one or more premiums for exchange of some form of remuneration.[970] However, the exact meaning of this is not clarified. Ultimately, the contribution referred to under the second type may also be considered a premium. But, if this interpretation is followed, the second type of agreement would then largely become redundant. Hence, it is submitted that the term "premium" merely refers to the payment (in cash or in kind) within the framework of the investment in insurance products.

The second type of contract requires a "contribution" of the economic rights, shares or assets of a type one or two legal arrangement.[971] Unfortunately, the term contribution is not defined. However, the explanatory memorandum refers to packaging. Despite the peculiar use of the term contribution, it appears that the intention was to ensure that the inclusion of a legal construction in a contract will no longer prevent the application of the Cayman tax regime.

Both type three legal arrangements require that a disbursement or distribution is provided in return for premiums or contributions.[972] The first agreement provides for the pay-out of the income realised in the underlying type one or two legal arrangement

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[969] Appermont et al *De Kaaimantaks: Panta Rhei* 131.

[970] *Code des impôts sur les revenus* 1992 art 2, 1 13c.

[971] European Union "Country Profiles" <https://european-union.europa.eu/principles-countries-history/country-profiles_en> (accessed 25-02-2022).

[972] Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* 1102.

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or the distribution of the economic rights, shares or assets of said legal arrangement. The second agreement provides for the payment or distribution of either the rights, shares, or assets contributed or their counter value. However, the provision does not clarify the distinction between the concepts of payment and distribution.[973] In any case, a difference seems to be recognised between a contribution and the payment of premiums.[974] In the case of a contribution, reference is made to a counter value for the actual value of the contribution, whereas in the case of premiums, a clearer link is made to the income achieved by the underlying legal arrangement.

Regardless of whether the distribution of income or other values takes place during the term of the agreement or at the end, the income obtained by the legal arrangement is taxed on behalf of the underlying founder at the time it was obtained by the legal arrangement and as if this founder had obtained it directly.[975] In the case of a distribution to a beneficiary, this income is deemed to be a dividend and taxed accordingly.[976]

Although the most prominent form of type three arrangements is likely to relate to insurance contracts,[977] the ambit is not limited to the aforesaid category. Instead, all possible contracts behind which a type one or type two legal arrangement is concealed could potentially be affected.[978] However, for the time being, which contracts exactly are included remains unknown. For example, will an annuity contract concluded in exchange for the surrender of shares be targeted by the type three legal arrangement?

To this extent, it is submitted that further clarification is necessary. After all, in contrast to the type two legal constructions, no official list was provided. Thus, the taxpayer will always have to decide whether a legal arrangement satisfies the characteristics of the definition.

In light of the above, it is submitted that the aim was probably to introduce a sort of “catch-all” provision in order to give the Cayman tax regime the widest possible scope. In this way, in theory, “any” agreement of a “contractual nature”, insofar as

[973] *Code des impôts sur les revenus* 1992 art 2, 1 13c.
[974] Goyvaerts (2018) *TFR* 644.
[975] *Code des impôts sur les revenus* 1992 art 5/1, 1.
[976] Article 18, paras 1, 3 2.
[977] Appermont et al *De Kaaimantaks: Panta Rhei* 123.
[978] Belgische Kamer van Volksvertengenwoordigers “Ontwerp van Programmawet” (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

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"during the course of the contract" or at "expiry of the contract", provision is made for the payment or distribution of the rights, shares or assets contributed to a type one or two legal arrangement, or of the counter value thereof, would qualify as a type three legal arrangement.

Yet the explanatory memorandum states that the provision is limited to a contribution to a product and not to other contracts.[979] However, the use of such vague terminology just results in legal uncertainty and can only be regretted. One will have to wait for the future application to see how broadly this provision must be interpreted.

5 4 1 2 4 Double structures

The previous discussions show that, although the Cayman tax legislation sometimes uses vague concepts to allow a wider scope, it is always necessary to verify precisely whether a certain form of asset structuring meets the conditions set out in the legislation.[980] To this extent, the principle of legality compels a strict interpretation of the applicable tax law.[981]

However, the limits of this interpretation seem to have been pushed a few times by the Service for Advance rulings. As alluded to, the Belgian Advance Tax Ruling Authority first surprised in the context of the certified partnership.[982] Subsequently, the Preliminary Decisions Department also sought a link to bring so-called double structures within the scope of the Cayman tax regime.[983] These are structures in which various legal constructions are brought together, further breaking the link between the ultimate founder and beneficiary and the level at which income is generated.[984] The question then arose whether tax transparency could also be applied through these different levels to attribute the income earned directly to the ultimate founder.

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[979] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

[980] Appermont *De Trust Een Juridisch Kader voor de (Internationaal) Privaatrechtelijke Inpassing en Fiscale Gevolgen* 1102.

[981] Couturier, Peeters & van der Velde "Belgisch belastingrecht in hoofdlijnen" (2018).

[982] Preliminary Decision No 2015.538 of 22 December 2015; Preliminary Decision No 2016.613 of 18 October 2016; Preliminary Decision No 2017.132 of 4 April 2017.

[983] Preliminary Decision No 2016.564 of 22 November 2016. Preliminary Decision No 2016.610 of 22 November 2016. Preliminary Decision No 2016.576 of 29 November 2016.

[984] Debelva, Vanderkerkhove & Verachtert "Ontsnappen dubbelstructuren steeds aan de kaaimantaks?" *Fisc. Act* 4.

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After the Advance Tax Ruling Authority gave its opinion on this issue, the legislator addressed the problem by adding an additional framework to the Cayman tax regime.[985] But, this differs from the "solution" previously applied by the Advance Tax Ruling Authority. However, this aspect will not be further discussed. Instead, the discussion will commence with providing a general overview of the problem, followed by a brief discussion of the legislative framework.

The use of "double structures" raises various questions in the context of the Cayman Tax legislation. First of all, it has to be defined which type of asset structure is to be considered as a legal arrangement.[986] Furthermore, is the set of superimposed legal figures considered a single legal arrangement, or are there several separate legal arrangements?[987]

Second, the question arises as to who can be regarded as the founder of a legal arrangement in a dual structure.[988] In this context, a distinction can be made, for example, depending on whether a legal arrangement was set up and then transferred its assets (in whole or in part) to a new entity or whether the founder of a legal arrangement transfers his rights in the arrangement to another legal entity and thus shifts them between him and the initial legal arrangement.

The previous question is then related to how the income obtained within this accumulated or tiered structure can be taxed.[989] Moreover, what classification does the income obtain, and when can the ultimate founder be taxed on it?

Unlike the Advance Tax Ruling Authority,[990] which sought solutions in a broadened definition of an indirect founder, a generalised description of a legal construction type one or an application of the general anti-abuse provision, the subsequent amendment directly addresses the problem of double constructs.[991]

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[985] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[986] Appermont et al *De Kaaimantaks: Panta Rhei* 123.
[987] GD Goyvaerts "De kaaimantaks 2.0. Een korte inleidingover volkomen en onvolkomen fiscale transparantie anno 2018" (2017) *TBF.*
[988] Goyvaerts (2019) *Trusts & Trustees* 213.
[989] Goyvaerts (2018) *TFR* 660.
[990] Preliminary Decision No 2016.564 of 22 November 2016; Preliminary Decision No 2016.610 of 22 November 2016; Preliminary Decision No 2016.576 of 29 November 2016.
[991] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.

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To this extent, income acquired within a chain construction is transparently allocated proportionally to the highest parent construction, after which the Cayman tax applies in full.

Although the explanatory memorandum continues to use the term dual structures,[992] this is not the case in the legislation itself. Instead, the amendment introduced the concepts of a "subsidiary structure", a "parent structure" and a "chain structure".[993] By using the terms subsidiary and parent, the legislator makes it possible to use the notion of chain construction to define a chain of a potentially indefinite length.

Thus, the aforesaid can be defined as: a subsidiary means a legal arrangement where the shares or economic rights of which are held, in whole or in part, by another legal arrangement.[994] Conversely, a parent arrangement means a legal arrangement that holds all or part of another legal arrangement's shares or economic rights.[995]

Time and again, reference is made to the possession of "shares" or "economic rights". But what exactly is meant by the latter concept has again not been clarified. In light of the former, how should the rights in a trust be calculated when a trustee, in the course of administering a trust, transfers part of the assets to another new trust? The use of vague terminology thus once again leads to legal uncertainty, which is regrettable.

However, the partial retention of rights of another legal construction is sufficient, with no minimum participation threshold. Even if only a very limited percentage were to be held, it would constitute a parent/subsidiary construction. In such a case, the liability to the tax charge will be limited to the percentage held.[996]

In addition, the definitions of subsidiary and parent structures were not further delineated in light of the three legal categories. Here, too, the aim appears to have been to give the articles the widest possible effect. Theoretically, all types can be both parent and subsidiary structures. However, in practice, it does not seem likely that a type three legal arrangement would itself qualify as a parent or subsidiary

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[992] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[993] *Code des impôts sur les revenus* 1992 art 2, 1 137.
[994] Article 2, 1 137/4.
[995] Article 2, 1, 137/2.
[996] Article 5/1, 1 para 2.

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arrangement. After all, the construction of such a legal construction in itself already requires an underlying type one or two legal construction.[997]

Furthermore, the notion of a chain construction can be defined as follows: a set of legal arrangements formed by a legal construction and all its subsidiaries.[998]

Thus, if the chain construction contains a subsidiary construction that is also a parent construction, the subsidiary constructions of this parent construction are also part of the same chain of legal constructions.[999]

The above determination is repeated until all subsidiary constructs of the parent constructions that are part of the chain construct are included in this chain construction.[1000]

Based on the above, the whole is not considered a single legal construction in itself. The individuality of each separate legal construct in the chain is recognised, and the chain is only maintained in so far as each individual link also qualifies as a legal construct. As soon as the chain is broken by inserting a legal entity that does not qualify as a legal construct within the sense of the Cayman tax, the transparency regulation as such cannot be applied any further. But in such a case, the Belgian tax administration can still rely on the general anti-avoidance provisions.[1001]

Moreover, in most cases, when the chain is broken by the inclusion of a non-qualifying legal construct, the exclusion of the Cayman tax will be detrimental to a valuation in Belgium. However, this should not always be the case. After all, in the event of a further distribution, fiscal transparency no longer plays a role, but the income is still distributed and may be taxable on a different basis.

Finally, the lack of clarity also persists regarding the reporting obligation. After all, a taxpayer is only obliged to report the legal construction of which he is a founder or from which he has obtained a dividend or any other benefit.[1002] But, by virtue of the rules on chain structures, income can be attributed to the parent structure and then

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[997] Article 2, 1 13c.
[998] Article 2, 1, 137/4.
[999] Goyvaerts (2019) *Trusts & Trustees* 220.
[1000] Goyvaerts "De kaaimantaks 2.0. Een korte inleidingover volkomen en onvolkomen fiscale transparantie anno 2018" *TBF*.
[1001] M Delanote & DE Phillipe "Les doubles structures et Particle 344, § 1 C1R: quels sont les actes posés par le contribuable susceptibles d'abus?" (2017) *RGCF* 234.
F Debelva & AM Vanderkerkhove "Antimisbruikbepalingen en dubbelstructuren: enkele bedenkingen" (2016) 30 *Fisc. Act.5.*
[1002] *Code des impôts sur les revenus* 1992 art 307, 1/1.

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taxed on the part of a taxpayer.[1003] However, the Belgian taxpayer will not have to report all legal constructions in the chain, but only the ultimate parent construction.

5 4 1 3 Exceptions

As shown throughout the previous paragraphs, the scope of the Cayman tax regime is very broad.[1004] Compounding the problem is the patchwork nature of the legislation and the subsequent amendments.[1005] This could lead to certain entities falling within the ambit of the look-through tax, although this was not in itself the intention of the legislator.[1006] After all, various situations are conceivable in which a foreign legal arrangement is not subject to tax, or is subject to a low rate of tax without this giving rise to any tax abuse.[1007] For example, it is not the intention to discourage the establishment of foreign-listed companies or entities engaged in asset management operations through public offerings of savings, in an institutional setting, in the context of pension allocation or occupational savings.

In order to limit the unintended consequences, the Cayman tax regime provides a number of explicit exceptions to the concept of legal arrangement.[1008] This means that even though all the requirements of the definition are satisfied, the legal entity will be excluded from the operation of the regime.[1009]

Aside from the aforesaid, provision is also made for a number of general exceptions. However, before a legal arrangement can invoke one of these exceptions, said legal arrangement must first constitute a legal arrangement under the definitions. This means that the exceptions are applicable regardless of the type of legal arrangement that is used. The only requirements are that the specific exclusion criteria are complied with.

To this extent, the Cayman tax regime is not applicable to the following arrangements: [1010]

[1003] Article 5/1, 1.
[1004] Appermont (2015) *AFT* 27.
[1005] Goyvaerts (2018) *TFR* 659.
[1006] Goyvaerts (2014) *Journal of International Tax, Trust and Corporate Planning* 51.
[1007] Appermont *De Trust Een juridisch kader voor de (internationaal) privaatrechtelijke inpassing en fiscale gevolgen* 1102.
[1008] Belgische Kamer van Volksvertengenwoordigers "Ontwerp van Programmawet" (06-11-2017) *Belgische Kamer van Volksvertengenwoordigers*.
[1009] *Code des impôts sur les revenus* 1992 art 2, 1, 137.
[1010] *Code des impôts sur les revenus* 1992 art 2, 1, 137.

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1. undertakings for collective investment;
2. a public or institutional alternative collective investment undertaking;
3. pension funds and legal forms in connection with the management of employee-participation schemes and
4. listed companies.

If one of the above exceptions applies, neither the transparency framework nor the reporting obligations under the Cayman tax regime will be applicable to the legal arrangement. However, various uncertainties remain regarding the exact scope of these exclusions. But a further discussion of these aspects falls outside the ambit of this dissertation and will not be dealt with.

In addition to the general exceptions, the Cayman tax regime also provides for some limited exceptions.[1011] These so-called special exceptions only apply in narrowly defined circumstances and have strict requirements. If applicable, the legal arrangement will only be exempt from the transparent taxation of income and not from the reporting obligations under the regime.[1012] Moreover, these special exceptions do not apply automatically, but must rather be invoked by the taxpayer. Furthermore, the onus of proof lies with the taxpayer. For purposes of this dissertation, the special exceptions will just be mentioned. A complete analysis of these aspects falls outside the scope and thus, will not be discussed.

In light of the above, the following limited exceptions are available under the Cayman tax regime:
1. minimum level of taxation;[1013] and
2. substance exclusion.[1014]

In summary, although a legal arrangement falls within the ambit of the Cayman tax regime, it does not necessarily mean that the arrangement's income will be subject to the transparency tax framework. Instead, it is possible that the arrangement is entirely excluded from the regime on the bases of the arrangement's operations or that one of

[1011] Goyvaerts (2019) *Trusts & Trustees* 222.
[1012] Goyvaerts (2015) *TFR* 901.
[1013] *Code des impôts sur les revenus* 1992 art 5/1, 3a.
[1014] Article 5/1, 3b.

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the general exceptions applies.[1015] Alternatively, the legal arrangement may qualify for one of the limited exceptions.[1016] However, the ultimate tax treatment will depend on the facts and circumstances of the case.

5 4 2 Conclusion

Because Belgium is a civil law jurisdiction, it is not familiar with the common-law trust concept. Instead, under Belgium domestic law, Belgium has so-called trust-like entities, but in actual fact, these entities are far from real trusts. While it is not possible to create a trust under Belgium law, Belgium does recognise the existence of foreign trusts. This is despite the fact that Belgium has neither signed nor ratified the Hague Convention of 1 July 1995 relating to the law applicable to trusts and their recognition. The International Private Law Act of 16 July 2004 introduced a legal definition of a trust in Belgian law. Accordingly, a trust is defined as: "a juridical relationship created by an act of the founder or by a juridical decision, by which property or rights are placed under the control of an administrator in order to administer them in the interest of one or several beneficiaries or with a specific purpose".

Under Belgium law, the Cayman tax regime governs the taxation of trusts. Although the founder is designated as the primary taxable party, Belgium still subscribes to the policy view that trust income must only be taxed once throughout the trust relationship. Thus, for the taxation of trusts, Belgium mainly taxes the founder of the trust. However, in the unlikely event that the Caman tax regime does not apply, it appears that Belgium uses a combination of systems depending on the specific circumstances.

Regardless of the legal nature of the taxpayer, all taxpayers that are resident in Belgium are subject to tax, generally speaking, on their worldwide receipts and accruals, while non-resident taxpayers are usually only taxed on income from Belgium sources. However, there are some exceptions to the above.

Although Belgium has a range of anti-avoidance provisions that may have an effect on the parties in the trust relationship, it is only the Cayman tax regime that was

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[1015] Appermont *De Trust Een juridisch kader voor de (internationaal) privaatrechtelijke inpassing en fiscale gevolgen* 1102.
[1016] Goyvaerts (2018) *TFR* 659.

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specifically enacted for foreign legal constructs, with a strong emphasis on trusts. Hence, the Cayman tax regime can be described as a SAAR.

The Cayman tax regime is aimed at Belgium resident taxpayers, which use foreign structures to avoid or reduce their income tax liability in Belgium. To this extent, the regime targets private investment entities set up in low-tax foreign jurisdictions by private individuals and certain legal entities. In terms of the new regime, Belgian tax authorities can look through targeted offshore structures to directly tax founders and third-party beneficiaries on income derived by such structures.

By virtue of the Cayman tax, income received by or accrued to a qualifying foreign legal construct is deemed to be that of the founder and, accordingly, subject to tax in the founder's hands. Conversely, all distributions from such legal constructs to the founder and to third-party beneficiaries resident in Belgium are deemed to be dividends and treated as such for tax purposes. Therefore, the Cayman tax regime disregards the existence of qualifying legal constructs and instead tax the Belgium founders and beneficiaries on income received by the trust.

In addition, the Cayman tax regime also imposes a reporting obligation on the founder and beneficiaries. Thus, all persons classified as a founder or benefiting from the legal construct are required to disclose their interest in said legal construct to the authorities in their annual tax returns. Non-compliance with these mandatory disclosure requirements is met with hefty penalties.

Moreover, the regime also contains various fictions to ensure that no amounts escape Belgium taxation. In addition, ample provision is made for further specific anti-avoidance clauses, which authorities can invoke as a measure of last resort. Fortunately for taxpayers, provision is also made for some limited exceptions and defences.

Based on the above, it is evident that the Cayman tax regime was largely shaped around the authorities' scepticism and pre-conceived perceptions of trusts. Hence, the point of departure is that all trusts are used for devious activities. Notwithstanding the prominent feature of trusts throughout the regime, the Cayman tax regime's ambit extends way beyond trusts. Instead, the regime applies to three broad categories of legal constructs, which means, amongst others, entities such as trusts, foreign foundations, companies, contract types and other exotic structures are included in the regime.

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Although the Cayman tax regime applies to qualifying legal arrangements that are used to avoid Belgium income tax, it is not the legal arrangement itself that is the taxable person for purposes of the Cayman tax. Instead, it is the founder of the legal arrangement that is designated as the taxable party for said arrangement.

Thus, the categories of founder can be described as follows:

1. the initiator
2. the contributor
3. the heir
4. the holder of rights
5. the contractor

While the operation of the Cayman tax disregards the existence of the legal arrangement, it is evident that the Cayman tax does not completely negate the arrangement in its entirety. Indeed, in light of the Cayman tax, only the income from these legal arrangements will be taxed, if any, under a regime of fiscal transparency. Thus, the legal acts of the legal arrangements will not be ignored under civil or company law.

In defining the different types of legal arrangements, the notion of legal personality is largely used. Thus, in broad terms, type one legal arrangements cover entities without separate legal personality. Conversely, type two legal arrangements encapsulate those entities with legal personality. But both the type one and type two categories have specific requirements that need to be satisfied. Hence, not all entities without legal personality will automatically constitute a type one legal arrangement, nor will those with legal personality, by default, be regarded as type two legal arrangements.

In addition to the above, the ambit of the regime was subsequently expanded with the introduction of a further category of qualifying legal arrangements. However, this third category departed from the link to legal personality. Instead, the so-called type three legal arrangement relates to special legal agreements, by which one of the previous legal constructions is 'wrapped up' in an additional agreement. Thus, it appears that this third category functions as a catch-all provision. After all, the explanatory memorandum assumes that certain forms of 'packaging' would preclude the application of the Cayman tax regime.

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Finally, just because a legal arrangement falls within the ambit of the Cayman tax regime, it does not necessarily mean that the legal arrangement's income will be subject to the transparency tax framework. Instead, it is possible that the arrangement is entirely excluded from the regime on the bases of the arrangement's operations or that one of the general exceptions applies. Alternatively, it is possible that the legal arrangement may qualify for one of the limited exceptions. However, the ultimate tax treatment will depend on the facts and circumstances of the case.

Furthermore, the operation of the Cayman tax regime can be severe. If a person is designated as the founder of a legal arrangement, said person will be regarded as the founder for said arrangement until the arrangement is dissolved, the person dies or if one of the exceptions applies. In the absence of the former, there is no way for a founder to be released from the classification as founder. Hence, unless one of the aforesaid is applicable, the designated founder will continually be taxed on all the undistributed income that is received, or that accrues to the non-resident trust. But, even if the founder dies, the liability to tax is passed on to the deceased founder's heirs, since the definition also classifies the heirs as founders of the legal arrangement. Unless they can show that neither they, nor their heirs will ever benefit from the arrangement. However, the onus of proof is always on the taxpayer.

While the Cayman tax regime sought to address the potential tax avoidance by Belgium resident taxpayers through the use of foreign entities, the point of departure for the regime was based on biased views of trusts. Thus, with the pre-conceived perception as the foundation for the regime, the framework was bound to be problematic. Not only is the ambit of the Cayman tax regime exceptionally broad, but the legislative framework is also very poorly drafted. In turn, this results in numerous interpretation challenges and a range of unintended consequences. The problems are further compounded by the various subsequent amendments, which resulted in an incoherent framework. The end result is a regime with an overly wide ambit and uncertainty for taxpayers. However, overall, the Cayman tax regime mainly achieves the stated objective, but it can only be described as a sledgehammer approach. If the regime had been better planned and a more objective perspective followed, many of the issues could have been prevented.

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5 5 Comparison of jurisdictions

Based on the proceeding discussion, it is clear that the different jurisdictions face the same challenge of tax avoidance. All jurisdictions are dependent on tax revenue but ensuring compliance by all remains elusive. For the revenue authorities, ensuring that all income is subjected to the appropriate tax treatment is paramount. For this to be successful, income must undergo taxation at the correct time, while safeguarding the principle that income must always only be taxed once. This can be challenging in the context of the trust relationship, where multiple parties are involved. Furthermore, many factors influence the level of adherence to tax legislation, but ultimately it comes down to fairness. This largely depends on the taxpayers' perception, but the government must ensure that the tax system is as fair as possible. This is easier said than done, and often it turns out to be a difficult balancing act. Thus, it is not surprising that the notion of tax avoidance is problematic across the board, more specifically, the phenomenon where taxpayers use trusts to unduly avoid or to minimise their tax liability. Such arrangements typically derive a benefit or advantage through exploiting gaps in the legislation or using certain provisions in a way that was not intended by the legislator. This is despite the fact that the trust structure was not created for such purpose. However, the way in which the jurisdictions go about addressing the problem differs vastly. The method adopted is largely determined by the jurisdiction's policy stance, taxation framework and attitude towards trusts in general.

One affective tool to combat tax avoidance is the use of SAARs. Especially if the SAARs are well designed and used in conjunction with more general measures. The purpose of a SAAR is to prevent specific arrangements that are regarded as abusive or unwanted. Such arrangements attempt to derive an unintended tax benefit or tries to circumvent a taxpayer's tax obligation. If successful, said arrangement will result in an unjust reduction in the taxpayer's tax liability.

This strategy is widely used worldwide, including by all the jurisdictions analysed in this dissertation. However, not all the SAARs deployed are equal. Although, in broad terms, the objectives of the various SAARs pertaining to trusts of each jurisdiction overlap, many SAARs encountered are poorly drafted. Closely related, the set of SAARs is often incoherent, with one SAAR contradicting another. This results in unnecessary complexity, reduced compliance, and an overall diminished outcome.

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These problems are especially prominent in the UK and Belgium but are also encountered in South Africa.

Despite the various differences, all the jurisdictions subscribe to the policy position that income received by a trust must only be subject to tax once throughout the trust relationship. Thus, for the taxation of trusts, South Africa primarily applies an initial choice system. The UK mainly uses the credit system. Conversely, Belgium largely taxes the founder of the trust. However, all three jurisdictions also view the trust structure as a hybrid flow-through entity. Aside from the aforementioned methods, all the jurisdictions further apply a combination of systems depending on the facts and circumstances of the case.

In all three jurisdictions, by virtue of SAARs, income received by or that accrues to a trust is deemed to be that of the founder and taxed accordingly in the founder's hands. This appears to be the default position in all jurisdictions. However, it is also possible that the operation of a SAAR deems the income of the trust to be that of a beneficiary and taxes said income accordingly in the beneficiary's hands. Moreover, under specific circumstances, the application of a SAAR can impose the liability to tax on someone outside the trust relationship. In South Africa and the UK, such practice is fairly widespread. But in Belgium, it is much more limited.

Although all the jurisdictions have SAARs that specifically focus on the use of trusts, the way the provisions are structured and the extent of said provisions differs greatly. On the one hand, Belgium predominantly uses the so-called Cayman tax regime. This regime can best be described as a general taxation framework for trusts. Only in the exceptional instance that the Cayman tax regime does not apply are the other provisions potentially applicable. While it is only the Cayman tax regime that is specifically enacted to govern the use of trusts, the regime has an incredibly wide ambit.

South Africa has a collection of single SAARs. Each of these provisions is drafted in such a way as to cover a specific type of arrangement. However, these provisions are formulated rather broadly, and hence, apply to a wide range of circumstances. This is in contrast to the UK, which has an exceptionally comprehensive set of SAARs. Unlike South Africa that uses single SAARs, or Belgium that only has the Cayman tax regime, in the case of the UK, the SAARs are divided into various sub-regimes that target abroad theme. Each of these so-called sub-regimes consists of a range of provisions, which govern almost every aspect pertaining to the overarching theme.

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Every sub-regime focuses on a specific type of abuse, which ultimately ensures that all income received by or that accrues to a trust undergoes the appropriate tax treatment at the correct time. Cumulatively, these anti-avoidance provisions cover an extremely wide range of scenarios and permutations. However, in all the jurisdictions, before any of the anti-avoidance provisions can apply, all the requirements of the specific provision must be complied with.

The Belgium Cayman tax regime is aimed at Belgium resident taxpayers, which use foreign structures to avoid or reduce their income tax liability in Belgium. To this extent, the regime targets private investment entities set up in low-tax foreign jurisdictions by private individuals and certain legal entities. In terms of the new regime, Belgian tax authorities can look through targeted offshore structures to directly tax founders and third-party beneficiaries on income derived by such structures.

In pursuance to the Cayman tax, income received by or accrued to a qualifying foreign legal construct, is deemed to be that of the founder and taxed accordingly in the founder's hands. Conversely, all distributions from such legal constructs to the founder and to third-party beneficiaries resident in Belgium are deemed to be dividends for tax purposes. Therefore, the Cayman tax regime disregards the existence of qualifying legal constructs and instead tax the Belgium founders and beneficiaries.

In South Africa, the following SAARs are the most important in the context of trusts:

1. section 25B(2A);
2. section 7; and
3. section 7C.

Under UK law, the SAARs that are most relevant to trusts can broadly be divided into the following sub-regimes:

1. settlor-interested trusts;
2. transfer of assets; and
3. protected trusts.

The UK's settlor-interested trust regime, or so-called settlor charging provisions, contains a collection of provisions that target arrangements whereby settlors circumvent their tax liability or unduly reduce their tax charge by using income-splitting

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structures. Each of the charging provisions within the regime focuses on preventing a specific scenario or variation. The transfer of assets regime is a set of anti-avoidance provisions that focuses on arrangements whereby taxpayers shift income-producing assets to non-resident trusts in order to circumvent UK taxation. The regime consists of various charging provisions, which collectively operate to curb different forms of transfer arrangements. Each charging provision is aimed at a specific scenario, with its own set of defined requirements. All arrangements contemplated by these two sub-regimes can broadly be classified into one of the following three categories:

1. income payments;
2. capital sums; and
3. provided benefits.

In addition, the protected trust regime is a subset of the tax system, which governs the use of offshore trusts in the UK. More specifically, it applies to offshore trusts with foreign domiciliaries. Under the protected trust regime, all trusts that are established by non-UK domiciliaries are afforded a protected trust status. These so-called protected trusts are exempt from all the tax charges discussed throughout the chapter. However, the relief is only available if all the specific conditions of the charging provision are met and limited to the extent that the income is regarded as protected foreign source income. But once an event occurs that breaks the protected status, the entire trust will be subjected to the normal tax charges.

Across all three jurisdictions, the use of non-resident trusts by a taxpayer to minimise their tax liability is frequently encountered. Such arrangements attempt to exploit the differences in jurisdictions' tax rates. Since the jurisdictions in question all use a residency-based taxation system, resident taxpayers are generally taxed on their worldwide receipts and accruals, while non-resident taxpayers are typically only taxed on income from that jurisdiction. This means that if the income is not received by the resident taxpayer, but rather by a non-resident trust, the income is not taxable in the taxpayer's jurisdiction, unless it is from a source within that jurisdiction. Hence, the income is subjected to less tax than would have been the case if the taxpayer received it directly. Often, the income will be accumulated in the non-resident trust for a period, after which it will be distributed to the resident taxpayer. Because such distribution is capital in nature, the distribution is not subject to income tax in the resident taxpayer's hands. In this way, the resident taxpayer received the income, but

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without being subjected to income tax in that jurisdiction. For this reason, all the jurisdictions have enacted specific SAARs to limit the advantages of such arrangements and to try and curb such practice.

In South Africa, such arrangements are governed by section 25B(2A). By virtue of this provision, the accumulated income of a non-resident trust is subject to income tax in South Africa if said income is distributed to a South African resident beneficiary. This means that the South African income tax liability cannot be avoided by accumulating foreign source income in a non-resident trust, which is later distributed as a capital sum.

Thus, in summary, if any one of the following circumstances applies, section 25B(2A) will no longer be applicable:

1. If the beneficiary did not have a contingent right when the income accrued to the trust.
2. If the beneficiary is not a resident at the time that the beneficiary acquires a vested right to the capital, even if the beneficiary was a resident while the beneficiary had a contingent right to the trust income.
3. If the trust capital that is being distributed to a capital beneficiary truly arises from income that was capitalised in the trust over a period of time.
4. If the income has already been subject to tax in South Africa.
5. If the receipts and accruals of the trust did not constitute income as defined.

Unlike South Africa, the UK does not have a single SAAR that deals with such arrangements. Instead, such an arrangement will be caught by either the capital sum provisions of the settlor-interested trust regime or that of the transfer of assets regime. Ultimately, which provision will be applicable will depend on the circumstances.

If the non-resident trust is settlor interested, section 633 will apply. In such case, the provision deems the capital payments received from the trust as the income of the settlor and said income is subsequently taxed in the settlor’s hands. Based on the attribution rules, the income can be included in the settlor’s tax assessment, subject to the available income in the trust for that year, or can continue for a maximum duration of ten years.

The provision targets the situation where the trustees of a settlement make capital payments to the settlor of said settlement. The capital benefits in question are made out of undistributed trust income. This means the trustees have already paid tax

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on the accumulated income as it arose, which is then distributed to the settlor in a later tax year. The problem of the aforesaid, is that the tax rate applicable to the settlor may be substantially higher than the rates applicable to the trust, which would then result in a reduced tax liability.

However, if the accumulated income resulted from a relevant transaction, section 727 of the transfer of assets regime will be applicable. In such case, the provision is aimed at the situation where UK resident individual taxpayer transfers assets to a non-resident in order to avoid or to minimise their UK tax liability, but the accumulated income in the non-resident trust is paid as a capital sum to the UK resident. By virtue of the provision, section 727 does not deem the capital sum to be income; instead, it takes income which has become payable to persons abroad as a result of the transfer and deems that income to be that of the individual.

The provision contains the following three conditions that need to be satisfied before the tax charge can be levied upon the individual:

1. There must be a causal link between the income that became payable to the non-resident and the relevant transactions.
2. The capital sum must constitute a capital receipt.
3. The individual must be UK resident in the tax year.

The section 727 charge applies to income arising in the year in which the capital receipt condition is met. However, once that condition is met in one year, it is generally met in all future years of assessment. Thus, section 727, in principle, applies to the income of the person abroad in the year that the capital receipt condition is first met, but will also apply in all subsequent years of assessment.

In the case of Belgium, by virtue of the Cayman tax regime, all accumulated trust income that is subsequently distributed to a Belgium resident founder or beneficiary is deemed to be dividends and treated as such for tax purposes.

Although the Cayman tax regime applies to qualifying legal arrangements that are used to avoid Belgium income tax, it is not the legal arrangement itself that is the taxable person for purposes of the Cayman tax. Consequently, for the operation of the Cayman tax regime, one must identify a taxpayer to whom the income of a legal arrangement is attributed and who bears the reporting obligations. Once identified, these taxpayers are regarded as the taxable parties and hence, will be responsible for all tax duties of said arrangement.

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Under the Cayman tax regime, the concept of founder is paramount. To this extent, in order to cover all possible scenarios and permutations, the definition of founder contains five different subcategories of founders. There is no explicit hierarchy between the various categories. Instead, these categories are considered to be alternatives. Thus, if either one of the definitions applies to the circumstances, that subject is classified as the founder of that legal arrangement. Also, the definitions are not mutually exclusive. Hence, depending on the circumstances, it is possible that one legal arrangement can have numerous founders. The addition of a new founder does not affect the status of the other founders.

Thus, the categories of founder can be described as follows:

1. the initiator;
2. the contributor;
3. the heir;
4. the holder of rights; and
5. the contractor.

Moreover, with the exception of the third category, no provision is made for a founder to terminate the capacity of founder, unless the entire legal construct is dissolved. This means once a person is designated as a founder of the legal construct, they will always be deemed to be the founder of said legal construct.

In light of the above, it is evident that the different jurisdictions have adopted distinct methods of addressing the same problem. In South Africa, section 25B(2A) applies to a beneficiary with a contingent right to the trust income, which is accumulated and subsequently distributed. Conversely, in the UK, there are potentially two provisions that can be applied. If the non-resident trust is settlor interested, section 633 will apply, which taxes the capital sum in the settlor's hands. But if the distribution is as a result of a relevant transaction and section 727 of the transfer of assets regime instead applies, the tax liability is imposed on the transferer. This individual can either be a beneficiary or a third party. Under Belgium law, the Cayman tax deems all distributions from accumulated trust income as dividends. This means all such distributions to founders and beneficiaries will be taxed as dividends.

In addition, in South Africa, income tax is only levied on the distribution made to the resident beneficiary. There is no ongoing taxation that stems from the distribution. This is also the position under the Belgium Cayman tax regime unless the taxpayer

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constitutes a founder. In such a case, the founder will be taxed on all trust income. This position can be contrasted to the UK. In the UK, if a trust is determined to be settlor interested, all qualifying trust income will be taxed in the hands of the settlor. If a capital sum is received, said capital sum can be included in the settlor's taxable income over a maximum of ten years, whereafter it must be disregarded. But, if the transfer constitutes a relevant transaction and the transfer of assets regime is applicable, all income that becomes payable to the person abroad will be deemed to be that of the resident individual. This is the position not only for the current year of assessment but for all future years as well. Hence, it is not the capital sum that is distributed that is taxed in the transferer's hands, but all income that is received by the non-resident trust from that point forward.

Aside from using non-resident trusts, taxpayers often use income-splitting arrangements to avoid or minimise their tax liability. Such arrangements can take various forms, but the underlying rationale remains the same. In such a scenario, a taxpayer will transfer income-producing assets to someone who is not liable to tax or someone in a lower tax bracket than the transferer. Typically, this will take the form of a spouse or a minor child, but the permutations are not limited to the aforesaid. Thus, the income derived from the asset will be subject to less tax than would have been the case before the arrangement. For the purpose of such arrangements, trusts are widely used, but it is not limited to resident trusts. In addition, in most of these arrangements, the income-generating asset is transferred to the trust without due consideration received.

Under South African law, the general rule is that no tax liability can arise in the absence of a receipt or accrual. However, in certain circumstances, the ITA makes an exception to this rule. In such instances, income is attributed to another taxpayer, even though it did not accrue to, or was not received by that taxpayer.

In South Africa, such arrangements are governed by section 7. To this extent, section 7 was specifically enacted to curb income-splitting arrangements. By virtue of section 7, income which has accrued to the trust or to a beneficiary of a trust is deemed to accrue to someone else. This person is normally the person who orchestrated the accrual to not occur in his hands but rather in the hands of the other person (the beneficiary or the trust), with the aim of reducing the normal tax liability. Such an arrangement usually coincides with someone in a lower tax bracket.

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Although section 7 is of particular relevance to trusts, its application is not limited to trusts alone. It deals with income accrued by reason of a donation, settlement or other disposition. It further outlines the rules that regulate under which circumstances income that is the subject of a trust will not be taxed in the hands of the trust or of any beneficiary, but rather in the hands of the donor or founder of the trust. Despite the reference to donor, the operation of this provision is not limited to the founder, but to any person who falls within the ambit of any of the subsections. While each subsection has distinct requirements, there are also many similarities.

In the case of the UK, a similar principle is followed as in South Africa. Under certain circumstances, income received by or that accrues to a UK trust, will be deemed to be that of the settlor even though the settlor did not actually receive said income. If a trust is regarded as being settlor interested, or if one of the anti-avoidance provisions applies to the trust, the income will be attributed back to the settlor as if said settlor received the income. These provisions can be described as the settlor charging provisions. In such a case, the settlor will be liable for the income tax payable on the income.

Thus, the anti-avoidance provisions aim to prevent settlors from circumventing their tax liability by arranging their affairs so that their income is received by someone who is either chargeable to tax at a lower rate than the settlor or not chargeable to tax at all.

Under Belgium law, no specific provisions target such scenarios, but such arrangements will fall within the ambit of the Cayman tax regime. If a Belgium resident taxpayer transfers income-generating assets to a non-resident trust, the transferer will be designated as a founder. This means that all income received by the trust will be deemed to be that of the founder and taxed in the founder's hands. This position will remain until the trust is ultimately dissolved. This tax liability can even be passed on to the founder's heirs unless they reject the entire inheritance.

In both South Africa and the UK, there are specific provisions that deal with specific variations of income-splitting arrangements. In the case of South Africa, section 7(2) is aimed at income-splitting arrangements between spouses. In contrast, in the UK, there is no exclusive provision that targets arrangements involving spouses, but such arrangements will rather be caught by the general provisions of the settlor-interested trust regime. If the spouse can benefit from the settlement, such

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arrangement will constitute an interest in property for purposes of the settlor charging provisions and will hence be governed by section 624.

In South Africa, as a general rule, spouses are separately assessed for tax in respect of all income that is received by or that accrues to the individual spouses. However, section 7(2) targets the situation where taxpayers attempt to avoid or to reduce their tax liability by exploiting the fact that the spouses are taxed separately. Typically, this can take the form of transferring income-producing assets to the other spouse that falls on a lower tax band or by awarding excessive remuneration to a spouse from the trade operations of the other spouse. By virtue of the provision, the income that arises from the donation will be deemed to be that of the donor spouse and taxed accordingly in that spouse’s hands.

In the UK, section 624 is aimed at the situation where the settlor retains an interest in the property, but the income of said property is paid to someone else. Typically, in such arrangements, the other person would be someone who falls in a lower tax band than the settlor or someone below the tax threshold. The operation of this provision treats the income arising under the settlement as if the settlor owned those assets directly. By virtue of the application, the tax treatment of the income arising under the settlement is exactly the same as if the settlor retained said assets in direct ownership. However, before the provision can apply, one must ascertain whether the key requirement has been satisfied. The provision provides that the income arising under the settlement is treated as that of the settlor, but only if the settlor has an interest in the property from which the income is derived. This position will remain for as long as the settlor has an interest in the property, or up until the settlor’s death.

To this extent, section 625 contains the circumstances under which the settlor would be deemed to have an interest in the property. The provision is defined broadly, but it is explicitly stated that if the settlor’s spouse can receive payments from the settlement or if the property can be applied for the benefit of the settlor’s spouse, the settlor will have an interest in the property, and thus, the charging provision of section 624 will be applicable.

Based on the above, all three jurisdictions have measures in place to limit income-splitting arrangements between spouses. However, the operation and consequences of the SAARs across the three jurisdictions differ. In South Africa, it is only the income that is received by or that accrues to the recipient spouse, in

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consequence of the donation, which is deemed to be that of the donating spouse. This contrasts with the UK and Belgium. In the former, all the trust's income is deemed to be that of the settlor until the causal connection has been severed. While in Belgium, it is also all the trust income, but the capacity of founder cannot be relinquished. In such a case, the only option is to terminate the trust.

In addition, in South Africa, section 7(2) only applies to income accrued by reason of a donation, settlement or other disposition. Similarly, in the UK, a settlor will only have an interest in a property if there is some element of bounty present. Thus, in these jurisdictions, commercial transactions or arrangements at arm's length falls outside the ambit of the SAARs. In the case of the Belgium Cayman tax regime, the position is not so clear. Based on the legislative text, it is possible that both bountiful arrangements and transactions for consideration can be included. However, it is not reasonably tenable to regard every transfer under an agreement for consideration as a transfer for the purposes of the contributing founder definition. Hence, it is submitted that a restrictive meaning should be followed, which limits the inclusion of transactions for consideration to connected parties.

Closely related to the above scenario is the situation where the income-producing asset is not transferred to the spouse, but instead transferred to the transferer's minor child. In such a case the objective remains the same, but the minor child instead receives the income. Both South Africa and the UK have specific SAARs to address such variation. Under the Belgium Cayman tax regime, such an arrangement will be treated the same as the previous example.

In South Africa, under normal circumstances, income that accrues to or that is received by a minor in its own right will be subject to tax in the minor's hands if it exceeds the taxable threshold. However, if the income received by or accrued to is by reason of any donation, settlement or other disposition made by a person to his or her minor child or stepchild, it will trigger the effects of section 7(3) and be taxed accordingly.

Section 7(3) is aimed at preventing income splitting between parents and their minor children. By the application of this subsection, income produced by the asset subsequent to the donation of said asset, will be deemed to be that of the donor and taxed accordingly in the donor's hands.

In the UK, such arrangements will trigger the effect of section 629 of the settlor-interested trust regime. Section 629 is an anti-avoidance provision, which targets the

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situation where a settlor makes a settlement in favour of the settlor's minor child. The provision is aimed at preventing income splitting between parents and their minor children. By applying this provision, income that arises under a settlement is deemed to be that of the settlor and accordingly taxed in the settlor's hands.

If the provision applies, it deems the income that arises under the settlement to be that of the settlor parent. Thus, for tax purposes, the settlor is treated as if the settlor has received said income directly, notwithstanding the fact that the income had been received by or accrued to the minor, or had been expended or accumulated for the child's benefit.

In both South Africa and the UK, the ambit of the respective provisions is almost identical. Both provisions exclude a grandchild from the operation of the provision. In addition, the effect of both section 7(3) and section 629 is to deem the minor child's income to be that of the parent donor or parent settlor, respectively. However, under South African law, the income that is deemed to be that of the donor, is limited to the income that is in consequence of the donation. In contrast, in the UK, all the income that arises under the settlement is deemed that of the settlor parent. But, in both jurisdictions, the provision will operate until either the minor child obtains the age of majority or until the death of the settlor, whichever event occurs first.

Under South African law, while section 7(3) has the objective of preventing income splitting from occurring between the parent and the minor child, the purpose of section 7(4) is to prevent the circumvention of the anti-avoidance rule in section 7(3) through the use of a third party.

This provision is aimed at the instance where a parent makes a disposition involving an appreciable element of liberality or generosity to another person, or connected party to such person, in exchange for a donation to a trust which is created for the benefit of the former's minor child. In such a case, the income arising from the said donation will be deemed that of the parent.

Under UK law, there is no equivalent provision to South Africa's section 7(4), but this does not mean that such a scenario is left unabated. Based on the definition of "settlor", a person who has made with any other person a reciprocal arrangement for that other person to make or enter into a settlement, will also be regarded as a settlor of the settlement. This means that the parent of the minor beneficiary will also be a settlor of the settlement even though the parent did not create the settlement. Hence, section 629 will be applicable, and all income that is received under the settlement will

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be deemed to be that of the settlors and taxed accordingly. Since there is more than one settlor, the income will be attributed in equal proportions.

In the case of Belgium, such a reciprocal arrangement will also be caught by the Cayman tax regime. This is despite the fact that there is no specific provision that deals with such transactions. However, in pursuance to the first category of founder, any person who creates a trust will be regarded as the founder of that trust. This is regardless of who the beneficiaries are. Moreover, in the event that any person contributes assets to the trust, said person will also become a founder in accordance with the definition of the second category of founder.

Thus, although the methodologies differ, provision is made to prevent taxpayers from circumventing the anti-avoidance provision in all three jurisdictions. In South Africa, the legislature has opted to enact a separate subsection to deal with this problem, while the UK has adopted a sufficiently wide definition of the settlor to encapsulate such a scenario and hence, bring such arrangements within the ambit of the section 624 charge. Similarly, the Belgium Cayman tax regime has an equally broad ambit that applies to such scenarios.

Unlike the above-mentioned provisions, which aim to prevent tax avoidance from occurring by means of income splitting, in South Africa, section 7(5) is designed to prevent a specific type of tax avoidance arrangement.

The provision targets a situation where a person transfers assets to a trust without due consideration received but where the person makes the receipt of the income conditional. In other words, the receipt of the income is postponed or restricted subject to the occurrence of a specific event. The result is that the income cannot immediately be distributed to the beneficiaries but will rather be accumulated until the conditions are fulfilled. Such income is deemed to be that of the person who imposed the conditions and will accordingly be taxed in said person’s hands. This position will only cease to have effect upon the death of the donor or at the realisation of the event, whichever occurs first.

In the case of the UK, there is no comparable provision to that of South Africa’s section 7(5). In such an instance, the person who created the trust will be regarded as the settlor of the settlement, but whether the income that arises under the settlement can be attributed to the settlor will depend on the facts and circumstances of the case. Only if the settlor has an interest in the property, can section 624 apply. Ultimately,

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whether the receipt of the income is conditional on the realisation of a specified event has no bearing on the settlor's tax liability.

Similarly, under Belgium law, the person who created the trust, and the person who contributed assets to the trust will constitute founders, but whether or not the receipt of the income is conditional has no impact on the operation of the transparency framework. Thus, there is no equivalent provision to that of section 7(5) in South Africa.

Whereas section 7(5) targets a situation where a donor transfers assets to a trust but limits the beneficiaries' receipt of the income until the realisation of a specified event, South Africa's section 7(6) is aimed at the situation where a donor disposes of his income-producing assets to a trust, but reserves the right to revoke the donation unilaterally or to confer the benefits of said donation upon someone else.

This means that an act of revocation by the donor is envisaged in the provision. Should the donor invoke said right, it will result in the recipient of the subject matter being deprived of the benefit or cause a transfer to take place from the original intended beneficiary to the newly nominated beneficiary. Under such circumstances, for the duration that the donor retains these powers, all income received by or accrued to the specified beneficiaries is deemed to be that of the donor and, thus, taxed in the donor's hands.

However, as was the case with the discussion on section 7(4) and 7(5), under UK law, there is no equivalent standalone SAAR to South Africa's section 7(6). Instead, such arrangements will also be covered by the operation of section 624. Under such circumstances, if the settlor has a right of revocation, such power will constitute an interest in the property. Therefore, the income arising under the settlement will be deemed that of the settlor and taxed as such.

While in Belgium, there is no comparable provision to South Africa's section 7(6). Instead, the Cayman tax will apply if a person constitutes a founder. The terms of the trust deed are irrelevant in calculating the founder's tax liability.

In both the UK and South Africa, the operation of the SAAR will only cease at the death of the settlor or donor respectively. The only other circumstances that will result in the provision to terminate is if the trust deed is amended beforehand to remove the provision or clause that grants the settlor or donor the right of revocation. In contrast, in the case of Belgium, if a person is designated as founder, said person cannot relinquish the capacity. With the exception of the third category of founder, the only option to terminate the capacity of the founder is to unwind the trust.

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While the other South African anti-avoidance provisions of section 7 predominantly focus on tax minimisation arrangements among South African residents, section 7(8) aims to curb transactions to non-residents that attempt to reduce the resident donor's tax liability by transferring income-producing assets to the non-resident.

Section 7(8) aims to prevent or limit taxpayers from using offshore structures for tax avoidance arrangements. Such arrangements can take various forms but will typically entail taxpayers divesting income-producing assets from their personal capacity to an offshore trust structure. The arrangement or transaction must involve an appreciable element of liberality or generosity for the provision to apply. In such case, the income that arises from the donation will be deemed to be that of the resident donor and will be taxed accordingly in the donor's hands, provided that all the other requirements of the provision are satisfied.

Section 7(8) can be described as the companion provision to section 25B(2A). Where section 25B(2A) concerns capital distributions from non-resident trusts, section 7(8) deals with income that arises to a non-resident trust in consequence of a donation. This means that these two provisions operate in tandem with one another but never overlap.

In the UK, the position is comparable to that of South Africa. When a taxpayer transfers income-producing assets to a non-resident trust to avoid or minimise their UK income tax liability, either the settlor-interested trust regime or the transfer of assets regime may be applicable.

While section 633 concerns the payment of a capital sum, section 624 applies where the settlor retains an interest in the income. Although section 624 was previously encountered in other scenarios, the provision's ambit extends to non-resident trusts as well. In pursuance of the provision, the income under the settlement is deemed to be that of the settlor and accordingly taxed in the settlor's hands. But, if the settlement is not considered to be settlor interested, and hence, the settlor charging provisions cannot apply, it is possible that the transfer of assets regime can be invoked.

Whereas section 727 targets capital sums, section 720 is aimed at the situation where UK resident individual taxpayers transfer assets to a non-resident to avoid or to minimise their UK income tax liability, which results in income becoming payable to

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the person abroad. By virtue of the provision, the income that arises to the non-resident is deemed that of the transferor and taxed as such.

If section 720 applies to an arrangement, the provision assigns the liability to tax to the person to whom the income is treated as arising. However, before a liability to tax can be imposed on the individual for the income that is deemed to be received by said individual, three conditions need to be satisfied:

1. There must be a power to enjoy the income that arises to the person abroad, but the power to enjoy must be as a consequence of the relevant transfer, an associated operation or both.
2. The income of the person abroad must be subject to income tax, if the income in question was received by the UK resident individual.
3. The individual must be UK resident for the year of assessment.

Only if all the above requirements are fulfilled can the income that arises from the non-resident trust be attributed to the transferor for tax purposes. However, the provision does not extend to income that was already subjected to tax by virtue of another section of the income tax legislation.

In the case of Belgium, it is exactly this type of scenario for which the Cayman tax regime was enacted. Thus, if a Belgium resident taxpayer transfers assets to a non-resident trust, said resident will be designated as the founder of the non-resident trust. By virtue of the Cayman tax regime, all the income that is received by the trust will be taxed as if the founder directly received it.

Thus, it is evident that all the jurisdictions have SAARs in place to curb resident taxpayers from transferring assets to non-resident trusts. In the absence of such provisions, resident taxpayers could have avoided or reduced their tax liability in their home jurisdiction simply by shifting the income-producing assets to a non-resident trust. In such case, the income that arises to the non-resident trust would have been outside the reach of the home jurisdiction's revenue authority's ambit.

However, as with the other SAARs discussed, the operation and consequences of the jurisdictions' SAARs differ substantially. In all three jurisdictions, the requirements pertaining to the types of transactions covered are identical as discussed in the context of income splitting between spouses. This is also the case for the quantum of income that can be attributed to the person who makes the transfer. Furthermore, the duration of the income charge is also similar to the other SAARs

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discussed. Thus, all the aforesaid elements are the same throughout section 7, the settlor charging provisions, the transfer of asset regime and the Cayman tax regime, respectively, regardless of the specific scenario to which the SAAR applies.

Moreover, in all three jurisdictions, the SAAR will only apply to the extent that such income has not been subjected to tax. Hence, if the same income was already taxed in accordance with another provision, said SAAR will not apply. This is despite the fact that all the other requirements may have been satisfied.

Closely related to income-splitting strategies is the use of interest-free or low-interest loans to finance the acquisition of an asset in a trust. Before the enactment of the SAARs that targeted the use of trusts to avoid or minimise a taxpayer's tax liability, generally speaking, such practice was commercially commonplace, entirely compliant with the law, and incurred very few adverse fiscal consequences. By using interest-free or low-interest loans, it was possible to avoid potential estate duty or inheritance tax and donation or gift taxes if applicable in the jurisdiction.

In South Africa, it is exactly this practice that the legislator addressed with the enactment of section 7C. To this extent, the provision targets the situation where a person makes an interest-free or low-interest loan to a trust. In such a case, the operation of the provision deems the foregone interest on the loan to be a continual donation. This means that the donor will be liable for donations tax on the difference between the interest rate charged on the loan and the official rate of interest.

Due to the wording used in the provision, it applies to a wide range of circumstances. Since the enactment of section 7C, the provision has been amended numerous times. These amendments exacerbated the complexity of the provision, expanded the already wide ambit, and introduced far-reaching anti-avoidance rules.

In the case of the UK, the situation is similar to many of the other scenarios discussed previously. Instead of having an explicit standalone provision that deals with interest-free or low-interest loans to trusts, both the settlor-interested trust regime and the transfer of assets regime have such a wide ambit that beneficial loan arrangements are also covered.

As a point of departure, a trust is not settlor interested merely because:

1. the trustees may lend to the settlor, or purchase an asset from the settlor, on commercial terms; or
2. the trustees do lend to the settlor, or purchase an asset from the settlor, on commercial terms.

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Even though each of the above transactions involves a payment to the settlor, either in the form of the monies lent or for the purchase price of an asset, it does not create an interest in the settlement. This can be explained by interpreting the wording used in the provision. The word "payable" in section 625(1)(a) means payable in a manner conferring a benefit. For this reason, it is necessary to have an additional provision dealing with capital sums paid to the settlor.

However, this is not the case where interest-free and beneficial loans are concerned. In such a case, the granting of the loan by the settlor to the settlement will constitute an interest in the property. Thus, section 624 will be applicable and, as a result, the income that arises under the settlement will be deemed that of the settlor.

In addition, if the settlor or the settlor's spouse provides a loan to the settlement, which is then subsequently repaid to the settlor, section 633 is applicable. By virtue of section 633, the loan repayment by the trustees is treated as the payment of a capital sum to the settlor. For purposes of the provision, the terms of the loan are irrelevant. This means that it makes no difference whether the loan was interest-free or on full commercial terms. In such case, the capital sum paid will be deemed to be the income of the settlor, in accordance with the attribution rules.

Alternatively, if the transfer of assets regime is applicable, the transaction may give rise to the charge on capital sums. If a person abroad lends to a UK resident individual, the receipt of the loan amount constitutes a capital sum. Similarly, if a UK resident individual provides a loan to a non-resident, the repayment of such loan will be regarded as a capital sum in the resident individual's hands. Provided that all the other requirements are complied with, the provision takes income which has become payable to persons abroad as a result of the transfer and deems that income to be that of the individual.

Equally, depending on the circumstances, it is possible that section 731 can also apply where interest-free or beneficial loans are concerned. However, it is considered that if the loan is on commercial terms, there is no benefit for tax purposes. Only if the loan is provided on favourable terms or if the outstanding liability is subsequently waived will it give rise to a chargeable benefit. In such a case, the value of the benefit is not the face value of the debt waived but the market value.

Thus, a beneficial loan will constitute a benefit for tax purposes. A beneficial loan can either take the form of an interest-free loan, a low-interest loan or a loan that is on

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more favourable terms than what can be obtained in the open market. In such a case, the value of the benefit is equal to the official rate of interest on the outstanding loan amount. If interest is levied on the loan, the benefit is limited to the difference between the rate of interest actually charged and the official rate of interest.

In contrast, under the Belgium Cayman tax regime, no specific provision deals with interest-free or beneficial loan arrangements. However, since the Cayman tax regime can apply to both bountiful arrangements and transactions for consideration, an interest-free or beneficial loan will also be covered. Thus, in such a case, the person who makes the loan to the trust will be designated as a founder. This means that all the income that arises to the trust, will be deemed to be received by the founder directly and hence, taxed accordingly in the founder's hands.

Based on the above, it is clear that all three jurisdictions have some form of protection against the use of interest-free or low-interest loans to trusts. In South Africa, this is achieved by a combination of section 7 and 7C. By virtue of these provisions, an interest-free or beneficial loan can attract both donations tax and income tax consequences. In the UK, such arrangements are also included in the ambits of the settlor charging provisions and the transfer of assets regime. Due to the nature of the regimes, the ambits are much wider than merely interest-free or low-interest loans, but nevertheless, apply in such circumstances as well. Regardless of the provision applicable, the operation of said provision gives rise to an income tax charge. Conversely, the Belgium Cayman tax regime is also defined wide enough to cover loan arrangements. But in this case, the existence of the interest-free or beneficial loan, merely triggers the "founder" definition, which then invokes the greater Cayman tax regime.

Aside from the scenarios discussed, the UK further have SAARs that levy a tax charge on benefits received. Unlike the other jurisdictions, this charge extends to benefits received, which is not the receipt of money. To this extent, section 731 is the third and final substantive charging provision under the transfer of assets regime. The provision imposes a tax charge on the beneficiary on the value of the benefits received from the person abroad. For purposes of this provision, section 732 quantifies the benefits and treats said amount as the beneficiary's income. The charge operates concurrently with section 720 and section 727 but does not apply accumulatively to income that is already subject to income tax. The provision focuses on arrangements that are specifically crafted to fall outside the ambit of the other charging provisions

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but are nevertheless in line with the anti-avoidance objective. The provision predominantly applies to individuals who are not regarded as transferors but still receive a benefit from a non-resident person as a result of a relevant transfer. However, this does not mean that the charge cannot also apply to a transferor.

In contrast, in South Africa and Belgium, there are no equivalent provisions to that of the UK. It is unlikely that an arrangement that gives rise to a benefit other than the receipt of money will be covered by the SAARs discussed. The aforementioned SAARs are only aimed at the receipt of income, or the foregoing of interest that should have been charged.

In conclusion, all three jurisdictions have specific SAARs in place that focus on the use of trusts. Across the board, the types of situations identified as abusive or unwanted behaviour largely overlap. However, the method adopted and the reach of the interventions differ substantially. Belgium has opted for one general system with an extremely wide ambit. The system fails to target the problematic cases appropriately and instead applies a blanket approach. Conversely, South Africa adopted a somewhat minimalist approach, but deployed single-specific SAARs. But, in some cases, the provisions are redundant and reach too far. Conversely, the UK has of the most elaborate anti-avoidance provisions. However, such an array of SAARs has also resulted in unmatched complexity. The legislation is extensive, and the anti-avoidance provisions are extremely intricate. Notwithstanding the aforesaid, no jurisdiction has a perfect system.

In South Africa, there are various problems regarding the interpretation of key terms, and the exact demarcation of the ambits remains unresolved. However overall, the SAARs largely succeed in their objective, but questions have been raised about whether some of the provisions reach too far.

Due to the way the system is developed, in the UK, it almost defeats the whole objective. The problem is not that certain avoidance arrangements are not covered but that the regime is so convoluted that it is virtually impossible to determine a taxpayer's tax liability with certainty. Compounding the issue is the fact that due to the unmatched reach of the provisions, in most cases, more than one SAAR is potentially applicable to the given circumstances. Further adding to the woes is the patchwork nature of drafting and the ambiguous terms used. The result being that uncertainty remains pertaining to the interpretation of key terms and the exact demarcation of the ambits of various provisions. However, overall, the UK's anti-avoidance framework is robust

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and effective in preventing abusive or unwanted arrangements. But, the complexity and poor formulation hinder compliance, limiting the system's efficiency.

Finally, the Belgium Cayman tax regime sought to address the potential tax avoidance by Belgium resident taxpayers through the use of foreign entities, but the point of departure for the regime was based on biased views of trusts. Thus, with the pre-conceived perception as the foundation for the regime, the framework was bound to be problematic. Not only is the ambit of the Cayman tax regime exceptionally broad, but the legislative framework is also very poorly drafted. In turn, this results in numerous interpretation challenges and a range of unintended consequences. The problems are further compounded by the subsequent amendments, resulting in an incoherent framework. The end result is a regime with an overly wide ambit and uncertainty for taxpayers. However, overall, the Cayman tax regime mainly achieves the stated objective, but it can only be described as a sledgehammer approach. If the regime was better planned, and a more objective perspective followed, many of the issues could have been prevented.

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CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

6 1 Introduction

This study evaluated the South African income tax regime for investments using trusts. In order to achieve the stated objective, the South African position was compared to that of the United Kingdom ("UK") and Belgium. The dissertation commenced with an overview of the essential aspects of trusts in each of the jurisdictions[1]. This discussion formed the foundation of the chapters to follow. The dissertation then introduced and unpacked the notion of a "tax haven".[2] This was achieved by thoroughly analysing the core aspects and most crucial questions regarding tax havens. With the aforesaid as background, the dissertation shifted the focus to the general income tax treatment of trusts.[3] This chapter examined the different policy positions and the tax rules applicable to trusts. Finally, the dissertation turned to an in-depth discussion of the various special anti-avoidance rules that can apply to trusts.[4] This chapter concluded with a comparison of the positions adopted in the three jurisdictions.

The question that this dissertation set out to answer was formulated as follows: "Should the South African income tax regime in respect of trusts be reformed? If so, how can this be done to create a tax framework that will encourage investment, limit tax avoidance and curb capital outflows while considering South Africa's unique context and challenges?"

At the outset of the dissertation, the hypothesis was that the South African income tax regime for trusts should be reformed. Among other issues, it was thought that the current system is too complex, legislation is unclear, and trusts are taxed too heavily. However, the benefit of the knowledge gained by studying the taxation of trusts in all three jurisdictions raises the question of whether the proposition is still valid. Thus, the South African income tax regime for trusts must be briefly evaluated to reach a conclusion.

[1] See Chapter 2.
[2] See Chapter 3.
[3] See Chapter 4.
[4] See Chapter 5.

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6 2 The trust: relic or relevant?

The trust notion was introduced to South Africa during the British occupation. Shortly after that, South African courts were faced with pronouncing on cases where trusts were used. Over time, the courts developed the South African trust law.[5] Many concepts and doctrines were incompatible with the legal system and disregarded or modified. In later years, the legislator intervened by codifying certain aspects. Based on the aforementioned, a truly (and) uniquely South African trust regime came into existence.

Although the trust may not necessarily be the first choice for many to structure investments in South Africa, it can be incredibly effective if applied correctly. The hesitancy surrounding trusts in South Africa likely stems from the notorious adverse tax consequences associated herewith, coupled with the increased scrutiny from regulators. But this reluctance may have an international component as well. From a non-resident's perspective, contributing to this phenomenon is the lack of awareness surrounding the existence of South African trusts. This is further exacerbated if the trust concept is unknown in the non-resident's home jurisdiction. However, aside from the tax considerations, trusts have many other benefits, making the trust entity an attractive investment option.

An argument that is sometimes raised against the trust is that trusts are not transparent and serve to obscure a taxpayer's affairs. Although South Africa does not have a trust register like the UK or a register of Ultimate Beneficial Owners such as Belgium[6], the trust is still subject to an element of public oversight and various publication requirements. This is in contrast to a country like Mauritius, where trust affairs are significantly more private, with no mandatory disclosure or publicity requirements. It is submitted that sufficient safeguards must be in place to protect the beneficiaries' interest and to ensure that the trust structure is not used for illicit activities. However, such safeguards should not unduly compromise the privacy of the trust parties.

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[5] See Chapter 2 para 2 3.

[6] The Trust Property Control Act 57 of 1988 was recently amended to include the requirement for trusts to disclose their beneficiaries. See the General Laws (Anti-Money Laundering and Combatting Terrorism Financing) Amendment Act, 2022 (Act No. 22 of 2022).
However, the commencement date of these amendments was set at 01 April 2023. See Government Gazette Republic of South Africa Vol. 690 29 December 2022.

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Notwithstanding the aforementioned, South Africa's office of trusteeship is very well regulated. Before a trustee can act, the trustee must be authorised in writing by the Master.[7] This means that any juristic act by a trustee without authorisation will be deemed null and void. Furthermore, the Master requires a copy of the trust instrument before the trustees can act with the trust property. These documents are open to inspection by any individual that can show sufficient interest, but this is subject to the discretion of the Master.[8]

In addition, a trust ought to have an independent trustee. It is submitted that this ensures that the separation between control and enjoyment is maintained while protecting the beneficiaries' interests. Where there is no independent trustee, the trust will not be invalid on that basis, but the courts may well regard the trust as the alter ego of the founder.[9] This means that the trust structure will be disregarded in its entirety. This is especially paramount where the parties to the trust are related, such as in a family trust scenario. This occurrence forms part of the broader abuse of trust theme. It is often confused with the so-called "sham trust".[10]

Aside from an independent trustee, in certain circumstances, jurisdictions such as Mauritius provide for the appointment of a protector and/or an enforcer.[11] However, the concepts of protector and enforcer are foreign to South Africa. It is submitted that this is an area where South African law can be improved.

Under South African law, a trust constitutes a separate estate.[12] The trust itself cannot be the owner of assets, but rather the trustees, in their official capacity, are the owners. This forms the core idea of a trust, namely, the separation between ownership or control and that of enjoyment. It is specifically this aspect that distinguishes trusts from other entities. This unique phenomenon forms the backbone of the trust's unmatched versatility.

The ownership structure of the South African trust offers unique opportunities and protections to beneficiaries. Under South African law, the beneficiaries have various remedies available to ensure that the trustees comply with the prescripts of

[7] See Chapter 2 para 2 3 1 2.
[8] See Chapter 2 para 2 3 1 2.
[9] See Chapter 2 para 2 3 1 2.
[10] See Chapter 2 para 2 3 1 2.
[11] See Chapter 2 para 2 3 1 4.
[12] See Chapter 2 para 2 3 2.

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the trust deed.[13] Depending on the circumstances, this may include but is not limited to a claim for specific performance or holding the trustees personally liable if a breach of duties has occurred.

However, in South Africa, beneficiaries only have a personal right against the trustees. The aforesaid allows the beneficiaries to ensure that the trust is administered in accordance with the stipulations of the trust deed. This serves as a way to safeguard their interest or potential benefit under the trust. This personal right further confers the beneficiaries with the necessary *locus standi* to take legal action against the trustees if the trustees do not act within the parameters of the trust deed.[14]

Furthermore, the trustees hold the legal title of trust assets for the benefit of the beneficiaries. This enables beneficiaries to enjoy the trust property without having any real right thereto. The trust property does not form part of either the beneficiaries' or the trustees' personal estate.[15] It is submitted that this phenomenon enables many of the trust's applications. This separation is crucial to using trusts for estate planning and asset protection. In addition, this split between control and enjoyment also has a direct impact on other sections of the law. This may include but is not limited to insolvency law and matrimonial property law.

This means that all trust property is protected from the trustee's private creditors. Therefore, the trust cannot be held responsible for debts incurred by trustees in their private capacity.[16] The notion is also extended to claims by or against beneficiaries. This results in a situation where trust property remains outside the reach of beneficiaries' creditors unless the distribution is no longer conditional. Put differently, if vesting has occurred, the beneficiaries' creditors will be able to attach the distribution made by the trust. In such cases, the creditors are limited to attaching only that specific benefit. However, most trust deeds will make provision for the trustees to apply their discretion in such a way that no distribution is made to a beneficiary if their financial position poses a risk to the trust assets. Similarly, the trust's creditors are limited to trust property only and have no claim to the beneficiaries or the trustee's property in their private capacity.

[13] See Chapter 2 para 2 3 1 3.
[14] See Chapter 2 para 2 3 2 2.
[15] See Chapter 2 para 2 3 2 2.
[16] See Chapter 2 para 2 3 2 2.

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Unlike the UK and Mauritius, South Africa has not adopted the rule against perpetuity.[17] This means that there is no limitation on the period for which the trust can exist. It is submitted that South Africa's approach is preferred since it allows for unhindered inter-generational planning.

Trusts in South Africa can best be described as malleable entities.[18] Thus, the trust is an "all-purpose institution" and can be used to service an indefinite number of scenarios. It is exactly this flexibility and adaptability that a trust offers that makes it such a useful entity.

As a point of departure, the objective for using trusts can broadly be divided into the following main themes. Each of these groupings can contain several subcategories:

1. preservation of wealth;
2. tax planning;
3. business activities;
4. financial transactions;
5. maintenance; and
6. not for profit.

Aside from the better-known uses of trusts, in South Africa, trusts are also widely used to conduct business activities or to hold investments. This is especially prominent in family-owned businesses, but not limited to the aforesaid. Similar uses of trusts are encountered in the UK and Mauritius, but in Belgium, trusts are seldom used to conduct a trade.

In the context of South Africa, trusts are also frequently used to hold the shares of a private company. In such configuration, the private company is the trading or operating entity, and the family trust is the shareholder. In these structures, it is common for family members to be founders, trustees and/or beneficiaries of the trust. In most cases, some or all of the aforesaid family members are also directors of the company. Such configuration maximises the associated trust and company benefits. Moreover, similar arrangements are, for example, used in Belgium, albeit in the form of for example private foundations.

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[17] See Chapter 2 para 2 3 4 3.
[18] See Chapter 2 para 2 6.

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Under South African law, the criteria used for classifying trusts is fundamental in determining the types of trusts. Loosely stated, this means there is no set list of "types of trusts".[19] The grounds of trust classification are as follows: ownership, types of rights associated with beneficiaries, purpose, and method of formation.

The ownership trust is the most widely applied trust form in South Africa. Various permutations are possible, but the main distinguishing factor is whether it is a discretionary or vested trust. The aforesaid classifications refer to the types of rights afforded to the trust beneficiaries. This consideration also determines the legal position and the trust's tax treatment.

Of all the trust's characteristics, it is arguably the discretionary nature that sets it apart from other legal forms – coupled with the ability to receive income but to pass the income and all associated characteristics on to the beneficiary. Undoubtedly, not all trusts are discretionary. However, the greatest benefits are arguably afforded to those that are. In the case of discretionary trusts, the discretionary powers of trustees allow the trustees to differentiate the distributions to beneficiaries based on their unique circumstances. This means that the trustees can allocate the trust's resources where it is needed most. Unlike with companies, it is not required that all beneficiaries must get an equal distribution. Thus, this agile nature makes discretionary trusts well-suited for family contexts, especially if the power of the conduit pipe principle is harnessed.[20]

Regardless of the trust type, it is further possible to classify the trust according to its purpose. This is also the approach followed in the UK and Belgium, but in those contexts, the overarching distinction among the trust types can be classified into either fixed or interest in possession trusts or discretionary trusts. In Mauritius, the trust types are more specialised and are more rigid in form. As in South Africa, within these categories, the naming convention followed for trusts also largely refers to the primary object of the trust.

In conclusion, it is clear that in South Africa, the English law of trusts has not been subsumed. Instead, the courts have developed a uniquely South African trust. It is undeniable that English influence played a role in shaping the former, but substantial differences remain.

[19] See Chapter 2 para 2 3 3 and 2 3 4.
[20] See Chapter 4 para 4 3 3.

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Based on the above, the South African trust is well-suited for investments. The discretionary nature and the availability of the conduit pipe principle enable unmatched flexibility and adaptability. Furthermore, a reasonable balance is struck between privacy and transparency. It is submitted that this aspect can further be improved by adopting a trust register, but caution must be exercised not to undermine privacy. Although an element of public oversight is present, it is submitted that provision must be made for a protector and/or enforcer.

6 3 The trust as a person

Under South African law, a trust is not a juristic person. For this reason, it does not have a separate legal personality and is instead an accumulation of rights and liabilities.[21] This being said, in certain instances, legislation regards a trust as if it were a juristic person. This is done for operational and efficiency reasons but is only limited to the ambit of such act. The Income Tax Act 58 of 1962 ("ITA") is such an example. The result of granting such fictitious legal personality is that a trust is liable to tax in its own right and treated as such.

In both the UK and Belgium, trusts are not regarded as juristic entities, nor do trusts have separate legal personality.[22] However, unlike in South Africa, in the UK, it is not the trust itself that is regarded as the taxpayer, but the body of trustees is considered a separate taxpayer.[23]

In Mauritius, the situation is similar to that of South Africa. A trust is not regarded as a separate legal entity but as a legal relationship between the settlor and the trustees. However, legal personality is assigned to a trust within the ambit of the income tax act. Since a trust is equated with a company for tax purposes, trusts are taxed similarly to companies. Under the Cayman tax regime, Belgium largely applies a hybrid approach by combining a "look-through" principle, allocating income obtained by a trust to a Belgian resident taxpayer ("founder"), with a regime where beneficiaries may be taxed on distributions obtained from the trust.[24]

Despite the classification, a South African trust already shares many characteristics that are similar to that of a legal person. However, the trust's legal form

[21] See Chapter 2 para 2 3 2.
[22] See Chapter 4 para 4 4 1. and 4 5 1.
[23] See Chapter 4 para 4 4 4 1.
[24] See Chapter 5 para 5 4 1.

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makes them much more flexible than juristic entities. Advocating for the South African trust to be classified as a legal person may be tempting, but this will most likely mean that many of the trust's characteristics will have to be sacrificed. It is submitted that the potential benefits are insignificant compared to the damage it will cause to the South African trust.

Notwithstanding the aforementioned, the Davis tax committee ("DTC") recommended that trusts be taxed as separate entities similar to companies.[25] This means that the conduit pipe principle must be abolished, and trust income will instead only be taxed at a trust level, regardless of the circumstances. But, to date, neither of the aforesaid recommendations have been implemented.

While such changes to the taxation of trusts may aid in reducing the opportunity for abuse and simplify the administration for the revenue authorities, it is submitted that it is not advisable to adopt the approach followed in both Mauritius and Belgium, which deem all distributions from the trust to beneficiaries as dividends.

6 4 Tax rates for trusts

In South Africa, ownership trusts are taxed at a flat rate equal to that of the highest marginal tax rate of individuals. This currently stands at 45%.[26] No distinction is made for different types of income. For vested trusts, or if income is not accumulated in the discretionary trust but rather distributed to the beneficiaries, the income will be taxed in the hands of the beneficiaries according to the tax bands for individuals. The sliding scale ranges between 18% and 45%.[27]

Under UK law, there are different rules and applicable tax rates for different types of trusts and different types of income. Aside from the 1 000 pounds exemption, discretionary trusts are taxed at the highest rates. For dividend income, the tax rate is 38,1%, and all other income is taxed at 45%. Fixed or interest in possession trusts are taxed at the basic rate, regardless of the amount of income received. The basic rates are 7,5% for dividend income and 20% for other income. Bare trusts are taxed according to the progressive sliding scale that applies to individuals. The current tax bands range from 20% to 45%.[28]

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[25] See Chapter 5 para 5 2 3 1.
[26] See Chapter 4 para 4 3.
[27] See Chapter 4 para 4 6.
[28] See Chapter 4 para 4 6.

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In the case of Belgium, undistributed trust income is taxed in the founder's hands, according to the individual tax rates. The tax brackets start at 25% and increase all the way to 50%. All distributions from the trust to beneficiaries and to the founder of a trust are normally regarded as dividends and taxed at the dividend rate, which is currently 30%.[29]

Under Mauritian law, since trusts are equated to companies, all trusts are taxed at a flat rate of 15%. Under certain circumstances, it is possible that this can be reduced even further. The tax rate of 15% also extends to individuals. Thus, there is no big difference in whose hand the trust income is taxed, aside from some deductions that are only available to individuals.[30]

Although all the jurisdictions except Mauritius tax trusts at the marginal rate, it is submitted that this is an unjust burden. The taxation level should not be used to discourage the use of an entity type. In fact, the choice of which legal structure to use should hinge on legal characteristics, not tax considerations. Generally speaking, the tax treatment should be tax neutral unless there are convincing reasons to promote one structure above another.

Although the DTC recommended that trusts should be taxed as separate entities, it was explicitly stated that trusts should not be taxed at the same rate as companies but instead still at the marginal rate. The rationale for the difference is the notion that if trusts are taxed at a lower than the marginal rate, it will create an opportunity for tax avoidance. However, it is submitted that this reasoning is not convincing. Based on the above, it is submitted that South Africa should adopt a similar tax rate for trusts as Mauritius.

6 5 Basis for taxation

South Africa uses a residency-based taxation system. This is also the position in the UK, Belgium, and Mauritius, but the determination differs.[31] In all the jurisdictions, the test for determining a person's residency status depends on the type of person they are considered to be for tax purposes. The UK, South Africa and Belgium broadly distinguish between natural persons and legal persons. While Mauritius have specific

[29] See Chapter 4 para 4 6.
[30] See Chapter 3 para 3 7 2 1
[31] See Chapter 4 para 4 3 2.

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tests for each type of entity.[32] In the case of South Africa, the ITA does not refer to legal persons but rather adopts the wider phrase persons other than natural persons. Conversely, in the UK and Belgium, the legal person category is limited to those entities with separate legal personality. However, none of the three jurisdictions have a specific test for so-called opaque entities such as trusts. But this is not the case for Mauritius. In the case of the UK and Belgium, one rather looks to the underlining parties to establish its residency status. In South Africa, the phrase persons other than natural persons encapsulates trusts. Hence, the same test will apply to trusts.

Unlike in South Africa, in both the UK and Belgium, it is not the trust or the settlement that is resident for tax purposes but rather the trustees. To determine the trust's residency status, one needs to ascertain the residency status of the trustees and the settlor. In the case of Belgium, the residency status of the founder is much more important than that of the trustees. If the trust's founder is a Belgium resident, the Cayman tax regime will apply, and for all intents and purposes, the trust will be treated as a tax resident in Belgium. Also, Belgium resident trust beneficiaries may be taxed when receiving distributions stemming from a trust. Although Mauritius has a separate test for trusts, it still strongly relies on the residency status of the trustees and the settlor. To this extent, a trust will be regarded as a Mauritian resident if either the trust is administered in Mauritius and a majority of the trustees are resident in Mauritius or if the settlor of the trust was resident in Mauritius at the time the trust was established.

In South Africa, the trust is resident if it has been formed in South Africa or has its place of effective management in South Africa. It is submitted that the two-prong approach followed in Mauritius is preferred over that of the other jurisdictions. However, further research is required to determine the suitability of such an approach in South Africa.

6 6 The conduit pipe principle; friend or foe?

Under South African law, one of the most fundamental principles of the taxation of the trust concept is the so-called conduit pipe principle.[33] This common-law phenomenon

[32] See Chapter 4 para 4 3 2.
[33] See Chapter 4 para 4 3 3.

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arguably enables the unmatched flexibility and versatility of the trust structure and distinguishes the way trusts function from other entity types.

In contrast to South Africa, the UK has not adopted the conduit pipe principle into their law. If the trustees exercise their discretion in favour of the beneficiary, the income distributed by the discretionary trust to the beneficiary loses the income's original source, and from there on, the trust is regarded as the source of the income.[34] However, if trustees of a fixed or an interest in possession trust passes income on to the beneficiaries, such income will retain its original character in the hands of the beneficiaries.

Similar to the UK, Mauritius has also not subsumed the conduit pipe principle into their law. Instead, trusts are taxed as separate entities, while all distributions to beneficiaries are classified as dividends. This also means that the income received by the trust does not retain its identity but is deemed dividend income in the beneficiary's hands.

Since Belgium does not have a domestic trust law, the conduit pipe principle does not exist. Notwithstanding the aforesaid, the Cayman tax regime operates on a fully fiscal transparent basis *vis-à-vis* the so-called "founder(s)" coupled with a form of taxation at the moment of distribution in the hands of beneficiaries resident in Belgium. It is submitted that the Cayman tax regime implements a form of a quasi-conduit pipe principle.[35]

In conclusion, it is submitted that the notion of the conduit pipe principle forms a fundamental part of the South African trust structure and should be retained. Thus, the South African position is preferred above that of the other jurisdictions. Despite the DTC's recommendation that the conduit pipe principle must be abolished, it is submitted that this is not advisable.

6 7 The taxation of the trust parties

In South Africa, even though the trustee is the representative taxpayer of the trust, it is not necessarily the trustees that are assessed. In Mauritius, the position is similar.[36] Although the trustee is the agent or representative taxpayer of the trust, it is not always

[34] See Chapter 4 para 4 4 1 and 4 4 3.
[35] See Chapter 4 para 4 6.
[36] See Chapter 3 para 3 7 and 3 7 2 1.

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the trustees that are taxed. Depending on the facts, income derived from a trust can be taxed in the hands of the beneficiaries or the trust. This is in contrast to the UK, where trustees are liable to tax on all the income due to the trust, whether or not the trustees receive it.[37] Conversely, in Belgium, where the applicable legislation assumes that the trust is established abroad, the trust's founder is the party that remains principally liable for all taxes due on the income received by or that accrues to the trust.[38]

Depending on the circumstances, income derived by a South African trust can be taxed in the hands of the beneficiaries, the trust or the donor. However, income will always only be taxed once.[39] That is, either in the hands of the beneficiaries, donor or trust, but never both. This assignment is determined by virtue of section 25B, coupled with the anti-avoidance provisions contained in section 7.[40]

If section 7 is applicable to the circumstances, the working thereof will take preference. Section 25B, therefore, comes into operation only to the extent that section 7 does not already apply – but some authors are of the view that this does not extend to section 25B(2). However, it is submitted that such a reading is not correct and that the legislature should amend the provision to provide clarity. [41]

The consequence of section 25B is that the tax liability either lies with the trust or the beneficiaries, which are determined as follows:

1. An amount that is received by or accrues to a trust is deemed to have accrued to a beneficiary if that beneficiary is ascertained, has a vested right to the income, and the amount has been derived for the benefit of that beneficiary. In such a case, the beneficiary is liable to tax on the relevant amount, and the trust has no tax obligation in respect of that amount.
2. An amount that is received by or accrues to a trust is taxed in the hands of the trust if there is no ascertained beneficiary for whose benefit the amount was derived, which has a vested right to that income. In such a case, only the trust will be taxed on that income, not the beneficiary.

[37] See Chapter 4 para 4 4 4 1.
[38] See Chapter 4 para 4 5 2.
[39] See Chapter 4 para 4 3 1.
[40] See Chapter 4 para 4 3 4.
[41] See Chapter 4 para 4 3 4.

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If the trustees of a discretionary trust exercise their discretion in favour of a beneficiary during a particular year of assessment, the beneficiary will be regarded as having a vested right to that income and will consequently be subjected to tax on that income.[42]

Thus, vesting can occur in two ways:

1. in the case of a vesting trust, an amount is vested in a beneficiary based on and in accordance with the terms of the trust deed; or
2. in the case of a discretionary trust, the exercise of the trustee's discretion constitutes vesting in that beneficiary.

In addition, the section also regulates who may claim the allowable deductions associated with the relevant trust income. This means that the deductions are allocated between the trust and the beneficiaries in the same proportion as the income received or accrued to the parties in terms of the provision.

Sometimes, it is also possible that income derived by the trust is not taxable in the hands of the trust or in the hands of the beneficiaries but rather in the hands of another party. This will typically take the form of the settlor or donor. In such a case, the working of section 7 of the ITA will be applicable.

Although UK law recognises various trust types, each serving a specific purpose and having a unique application, the distinction's relevance is much more limited for tax purposes.[43] In the income tax realm, one must differentiate between two broad categories of trust types, which are taxed according to different rules, namely:

1. discretionary trusts; and
2. fixed or interest in possession trusts.

In the case of discretionary trusts, the income may be subject to accumulation or to distribution at the trustees' discretion, in line with the wishes of the settlor and the prescripts of the trust instrument, for which a special income tax regime applies.[44] Until the trustees have exercised their discretion, the beneficiaries will only have a hope to receive the income and, consequently, no form of entitlement or claim to the trust income.

[42] See Chapter 4 para 4 3 4.
[43] See Chapter 4 para 4 4 4.
[44] See Chapter 4 para 4 4 4.

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In the UK, discretionary trusts are taxed in accordance with a three-tiered system, which can be summarised as follows[45]:

1. a charge on the trustee on the receipt of the income;
2. a charge on the trustee on making a discretionary payment of income; and
3. a charge on the beneficiaries on receiving a discretionary payment of income.

Even though the income is taxed on different levels, the UK still subscribes to the policy view that trust income must only be subjected to taxation once throughout the trust relationship. This is achieved by providing appropriate tax credits to relieve possible double taxation.

Where fixed or interest in possession trusts are concerned, the income belongs to the beneficiaries as it arises, in accordance with the stipulations of the trust deed. Thus, the beneficiaries are already entitled to the income and are not subjected to the discretion of the trustees. Wide varieties and derivatives are available, depending on the specific circumstances of the parties. Notwithstanding the configuration, the overarching category is largely treated the same for income tax purposes.

In the case of discretionary trusts, none of the beneficiaries are entitled to the income unless the trustees make a distribution to that effect.[46] The tax system operates to ensure that all possible taxes due are collected at a trustee level and to prevent income from slipping through the tax net. As such, trustees are liable to tax on all the income due to the trust, regardless of whether the trustees receive it. In addition to the charge on the trustees at the receipt of the income, the trustees are further taxed when applying their discretion to distribute income to the beneficiaries.

Pertaining to distributions, the beneficiaries of a discretionary trust will have no tax liability unless the beneficiary is an additional rate taxpayer.[47] In all other cases, the beneficiaries may be able to claim a tax rebate for the difference between the taxes paid by the trustees when making the distribution and the beneficiaries' actual tax liability. However, where fixed or interest in possession trusts are concerned, the ultimate income tax liability will be determined by the recipient beneficiary's personal tax position. Only if the beneficiary is a basic rate taxpayer will there be no further tax liability for the beneficiary. If the trustees mandated income directly to the beneficiary,

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[45] See Chapter 4 para 4 4 4.
[46] See Chapter 4 para 4 4 4 1.
[47] See Chapter 4 para 4 4 3.

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the trustees have no income tax liability, and the beneficiary is simply taxed directly in relation to the income received.

In the UK, the founder or settlor is not usually taxed on trust income unless one of the anti-avoidance provisions applies.[48] Under such circumstances, the trust's income will be deemed to be that of the settlor for income tax purposes, even though the income is, in actual fact, neither received by nor accrued to the settlor. In such case, the settlor will be assessed on said income and consequently, be liable to the tax obligation that may arise.

Although it is not possible to create a trust under Belgium law, Belgium does recognise the existence of foreign trusts.[49] In light of the aforesaid, Belgium has no general tax regime for trusts, but the so-called Cayman tax regime is a form of a special anti-avoidance rule that regulates the taxation of foreign trusts in Belgium and which applies to almost all foreign trusts.[50] In the absence of the application of the Cayman tax, various provisions of the tax legislation, in conjunction with basic tax principles, can be used to impose Belgium income tax on the parties to a trust, but the success is subject to the specific facts and circumstances of the case.

However, it is worthwhile to note that the enactment of the Cayman tax regime did not repeal or override any of the general tax principles outlined above. Instead, the Cayman tax was introduced as an autonomous system of taxation that operates alongside previous Belgium tax principles.[51] Notwithstanding the aforesaid, it is considered that the Cayman tax regime is the default tax regime applicable to trusts in Belgium. Because of the wide scope of the Cayman tax, there are almost no cases where foreign trusts are still taxed in accordance with the general tax principles in Belgium.

The Cayman tax regime can be described as a regime of fiscal transparency that disregards the use of foreign legal structures by resident Belgium taxpayers.[52] By virtue of the Cayman tax, the income that accrues to, or that is received by such legal arrangements is deemed to have been received by the resident founders directly and taxed accordingly. Moreover, beneficiaries obtaining distributions from the trust may

[48] See Chapter 4 para 4 6.
[49] See Chapter 5 para 5 4.
[50] See Chapter 5 para 5 4 1.
[51] See Chapter 4 para 4 5 1.
[52] See Chapter 4 para 4 5 1.

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also be taxed, as Belgian tax law regards this distribution as a movable income obtained by the beneficiary. While the Cayman tax also has certain rules relating to the avoidance of double taxation in place, the Cayman tax applies attribution rules aimed at taxing the so-called "historical reserves" of the trust.[53] Concretely, this might mean that even where a Belgium resident founder has been taxed in trust income which is later distributed to a beneficiary, the beneficiary might again be taxed on said income, as the Cayman tax "assumes" that the distribution is made up out of previously obtained trust income, which has not yet been taxed under the ambit of the Cayman tax. It is up to the taxpayer to rebut this assumption. Aside from the notion of fiscal transparency, the regime introduces various fiscal fictions, a range of attribution rules and specific anti-avoidance rules. In certain respects, the Cayman tax is reminiscent of a Controlled Foreign Corporation ("CFC") regime.[54]

If a legal arrangement falls within the ambit of the Cayman tax, the founder of said arrangement will be the taxable party by default. The ambit of the Cayman tax extends beyond mere trusts, but trusts form an important component of the regime. If a foreign trust has a Belgium-resident founder, the income that is accumulated in the trust is deemed to be the income of the founder and taxed in the hands of the founder. In such a case, the foreign trust's income is taxed according to the individual income tax rules. Due to the transparent nature of the Cayman tax regime, the income will keep its "fiscal identity" (for example, immoveable income or movable income) when deemed to be that of the resident founder.[55] This means that the founder will be afforded all the benefits that they would have been entitled to if the income was received by the founder directly and not by the foreign trust.

However, if the foreign trust distributes the income received to the founder, such distribution will be deemed to be a dividend, and the founder will be taxed accordingly. Consequently, the distributed income will lose its identity and will be treated as a dividend. Under certain circumstances, the founder will not be taxed if the income was distributed to a third-party beneficiary, but it remains the founder that is primarily responsible for settling the tax charge.[56]

[53] See Chapter 5 para 5 4 1.
[54] See Chapter 5 para 5 4 1.
[55] See Chapter 5 para 5 4 1 1.
[56] See Chapter 5 para 5 4 1 1.

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In Mauritius, all distributions by a trust are regarded as a dividend for tax purposes, which means that the income will be taxed in the hands of the trust but will be exempted in the hands of the beneficiaries.[57] The normal flat rate of 15% will be applicable for the trust unless an exception applies. Where a resident beneficiary receives a distribution from a non-resident trust, that income will be treated as foreign source income. For this reason, it will be taxable at the rate of 15% unless either an exception is applicable or the beneficiary is an individual, and the income is not remitted to Mauritius.[58]

In addition, Mauritius does not have any attribution provisions, where the income derived by the trust is deemed to be that of the donor. This arguably stems from the fact that Mauritius does not impose any taxes on gifts or donations and has no estate or inheritance taxes.

6 8 Approach to trust taxation

For the taxation of trusts, South Africa primarily applies an initial choice system and also views the trust structure as a hybrid flow-through entity.[59]

Conversely, the UK mainly uses the credit system and also views the trust structure as a hybrid flow-through entity. If the Cayman tax regime applies, Belgium mainly taxes the founder of the trust on all the trust's income, while all distributions are taxed as dividends. In the case of Mauritius, trust income is either taxed in the hands of the trust or the beneficiaries.[60]

Although the credit system is advantageous for the revenue authority, it is very complex for taxpayers. According to such a system, all income is taxed in the hands of the trust, regardless of who will receive it. If the income is subsequently distributed to a beneficiary, the income is taxed according to the beneficiary's tax bracket. If the beneficiary falls on a lower tax band than that of the trust, a tax credit is provided to the beneficiary for the difference between the tax paid by the trust and the beneficiary's actual tax liability. Thus, despite the efficiency gains for the revenue authority, due to the complexity for the taxpayer, it is submitted that such an approach is not preferred. It is further submitted that there is possibly a strong correlation between the level of

[57] See Chapter 3 para 3 7 2 1.
[58] See Chapter 3 para 3 7 2 1.
[59] See Chapter 4 para 4 2.
[60] See Chapter 4 para 4 2.

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complexity of tax legislation and the compliance rate of taxpayers. Since the DTC has already flagged South Africa's alarmingly low compliance rate for trusts, introducing a new and arguably more complex tax system for trusts will not improve the problem but will instead will merely exacerbate the level of compliance.

Belgium taxes the founder of the trust on all income received by the trust, which is not distributed to a beneficiary.[61] However, the rationale for this approach is strongly correlated with the notion or perception that the settlor will retain substantial control over the trust assets and will not truly relinquish control to the trustees as is required under the trust structure. But it is submitted that such reasoning does not apply to all trusts. Hence, the approach does not make adequate provision for the wide range of circumstances in which trusts are and can be used. Notwithstanding the aforesaid, in South Africa, it is not really feasible to have such justification for the taxation system since a core principle of the South African trust is the separation of control and enjoyment. If the founder of the trust does not relinquish the trust property to the trustees, it may bring into question the validity of the trust.[62]

The DTC recommended that South Africa change how trusts are taxed. More specifically, it was proposed that the attribution rules and the conduit pipe principle must be abolished.[63] Instead, it was recommended that trusts are taxed as separate taxpayers. By extension, this also means that the initial choice system must be replaced. The rationale for such far-reaching recommendations stems from the notion that the aforesaid principles were originally enacted as part of the anti-avoidance efforts, but these rules are actually used to facilitate the exact opposite.

The existence of the conduit pipe principle and the attribution rules enables taxpayers to split the income that is received by the trust. Thus, income can be distributed to beneficiaries on much lower tax bands than the trust, resulting in sizable tax savings.[64]

In light of the above, despite the DTC's recommendations, it is submitted that South Africa's approach is preferred. The taxation framework complements the trust's inherent flexibility and adaptability. The combination of principles adopted means that

[61] See Chapter 4 para 4 2.
[62] See Chapter 4 para 4 2.
[63] See Chapter 5 para 5 2 3 1.
[64] See Chapter 5 para 5 2 3 1.

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sufficient provision is made for different circumstances while ensuring that all income is subjected to tax at the appropriate time.

6 9 Special anti-avoidance rules

All jurisdictions are dependent on tax revenue, but ensuring compliance by all remains elusive. For the revenue authorities, ensuring that all income is subjected to the appropriate tax treatment is paramount. For this to be successful, income must undergo taxation at the correct time while safeguarding the principle that income must always only be taxed once. This can be challenging in the context of the trust relationship, where multiple parties are involved.

Thus, it is not surprising that the notion of tax avoidance is problematic across the board. More specifically, the phenomenon where taxpayers use trusts to unduly avoid or to minimise their tax liability. Such arrangements typically derive a benefit or advantage by exploiting gaps in the legislation or using certain provisions in a way that was not intended. This is despite the fact that the trust structure was not created for such a purpose. However, the way in which the jurisdictions go about addressing the problem differs vastly. The method adopted is largely determined by the jurisdiction's policy stance, taxation framework and attitude towards trusts in general.

Except for Mauritius, all three other jurisdictions use specific anti-avoidance rules ("SAAR") to curb anti-avoidance arrangements.[65] Although, in broad terms, the objectives of the various SAARs pertaining to trusts of each jurisdiction overlap, many SAARs encountered are poorly drafted. Closely related, the set of SAARs is often incoherent, with one SAAR contradicting another. This results in unnecessary complexity, reduced compliance, and an overall diminished outcome.

In broad terms, the areas of concern for all jurisdictions are similar. Thus, one can identify common trends amongst the jurisdictions. However, the way in which each jurisdiction has opted to address the occurrence differs. The different approaches also have varying levels of success.

In summary, the jurisdictions have flagged the following overarching categories of arrangements as problematic:

1. non-resident trusts;
2. income splitting;

[65] See Chapter 5 para 5 1.

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3. retained interest;
4. interest-free or beneficial loans; and
5. benefits received.

In all three jurisdictions, by virtue of SAARs, income received by or that accrues to a trust is deemed to be that of the founder and taxed accordingly.[66] However, it is also possible that the operation of a SAAR deems the income of the trust to be that of a beneficiary and taxes said income accordingly in the beneficiary's hands. Moreover, under specific circumstances, the application of a SAAR can impose the liability to tax on someone outside the trust relationship. This notion that the founder or other party can be taxed on the trust's income is widely used as a deterrent.

In South Africa, the following SAARs are the most important in the context of trusts:

1. section 25B(2A);
2. section 7; and
3. section 7C.

Under UK law, the SAARs that are most relevant to trusts can broadly be divided into the following sub-regimes:[67]

1. settlor-interested trusts;
2. transfer of assets; and
3. protected trusts.

The UK's settlor-interested trust regime, or so-called settlor charging provisions, contains a collection of provisions targeting arrangements whereby settlors circumvent their tax liability or unduly reduce their tax charge using income-splitting structures.[68] Each of the charging provisions within the regime focuses on preventing a specific scenario or variation. The transfer of assets regime is a set of anti-avoidance provisions that focuses on arrangements whereby taxpayers shift income-producing assets to non-resident trusts to circumvent UK taxation. The regime consists of various charging provisions, which collectively operate to curb different forms of transfer

[66] See Chapter 5 para 5 1.
[67] See Chapter 5 para 5 3.
[68] See Chapter 5 para 5 3.

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arrangements. Each charging provision is aimed at a specific scenario, with its own set of defined requirements. All arrangements contemplated by these two sub-regimes can broadly be classified into one of the following three categories:

1. income payments;
2. capital sums; and
3. provided benefits.

In addition, the protected trust regime is a subset of the tax system, which governs the use of offshore trusts in the UK. More specifically, it applies to offshore trusts with foreign domiciliaries. Under the protected trust regime, all trusts that are established by non-UK domiciliaries are afforded a protected trust status.[69] These so-called protected trusts are exempt from all the tax charges discussed throughout the chapter. However, the relief is only available if all the specific conditions of the charging provision are met and limited to the extent that the income is regarded as protected foreign source income. But once an event occurs that breaks the protected status, the entire trust will be subjected to the normal tax charges.

In the case of Belgium, the Cayman tax regime was enacted alongside other tax measures but is the first legislative framework that specifically focuses on perceived tax avoidance using (non-resident) trusts and other low-tax legal entities in other jurisdictions.[70]

The Belgium Cayman tax regime is aimed at Belgium resident taxpayers, which use foreign structures to avoid or reduce their income tax liability in Belgium. To this extent, the regime targets private investment entities set up in low-tax foreign jurisdictions by private individuals and certain legal entities. In terms of the new regime, Belgian tax authorities can look through targeted offshore structures to directly tax founders and third-party beneficiaries on income derived by such structures.

Pursuant to the Cayman tax, income received by or accrued to a qualifying foreign legal construct is deemed to be that of the founder and taxed accordingly in the founder's hands. Conversely, all distributions from such legal constructs to the founder and third-party beneficiaries resident in Belgium are deemed dividends for tax

[69] See Chapter 5 para 5 3 3.
[70] See Chapter 5 para 5 4.

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purposes. Therefore, the Cayman tax regime disregards the existence of qualifying legal constructs and instead taxes the Belgium founders and beneficiaries.

6 9 1 Non-resident trusts

Taxpayers' use of non-resident trusts to minimise their tax liability is frequently encountered across all three jurisdictions. With the exception of Mauritius, the other three jurisdictions under discussion have all enacted a number of SAARs to limit the tax benefits that can be achieved with such uses.

In South Africa, non-resident trusts are mainly governed by section 25B(2A) and section 7(8).[71] By virtue of section 25B(2A), the accumulated income of a non-resident trust is subject to income tax in South Africa if said income is distributed to a South African resident beneficiary. This means that the South African income tax liability cannot be avoided by accumulating foreign source income in a non-resident trust, which is later distributed as a capital sum.

While the other South African anti-avoidance provisions of section 7 predominantly focus on tax minimisation arrangements among South African residents, section 7(8) is aimed at curbing transactions to non-residents that attempt to reduce the resident donor's tax liability by transferring income-producing assets to the non-resident.[72] Thus, section 7(8) aims to prevent or limit taxpayers from using offshore structures for tax avoidance. In such case, the income that arises from the donation will be deemed to be that of the resident donor and will be taxed accordingly in the donor's hands, provided that all the other requirements of the provision are satisfied.

Section 7(8) can be described as the companion provision to section 25B(2A). Where section 25B(2A) concerns capital distributions from non-resident trusts, section 7(8) deals with income that arises to a non-resident trust as a consequence of a donation. This means that these two provisions operate in tandem with one another but never overlap.

In the UK, the position is comparable to that of South Africa. When a taxpayer transfers income-producing assets to a non-resident trust to avoid or minimise their UK income tax liability, it is possible that either the settlor-interested trust regime or

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[71] See Chapter 5 para 5 2 1 and 5 2 2 6.
[72] See Chapter 5 para 5 2 2 6.

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the transfer of assets regime is applicable. However, the facts and circumstances will determine which provision can be invoked.

If the non-resident trust is settlor interested, section 633 will apply.[73] In such case, the provision deems the capital payments received from the trust as the income of the settlor and said income is subsequently taxed in the settlor's hands. Based on the attribution rules, the income can be included in the settlor's tax assessment, subject to the available income in the trust for that year or can continue for a maximum duration of ten years.

However, if the accumulated income was a result of a relevant transaction, section 727 of the transfer of assets regime will instead be applicable.[74] By virtue of the provision, Section 727 does not deem the capital sum to be income; instead, it takes income which has become payable to persons abroad as a result of the transfer and deems that income to be that of the individual. The section 727 charge applies to income arising in the year in which the capital receipt condition is met. However, once that condition is met in one year, it is generally met in all future years of assessment. Thus, section 727, in principle, applies to the income of the person abroad in the year that the capital receipt condition is first met but will also apply in all subsequent years of assessment.

While section 633 concerns the payment of a capital sum, section 624 applies where the settlor retains an interest in the income. The provision's ambit extends to non-resident trusts as well. Pursuant to the provision, the income under the settlement is deemed to be that of the settlor and accordingly taxed in the settlor's hands. But, if the settlement is not considered to be settlor interested, and hence, the settlor charging provisions cannot apply, it is possible that the transfer of assets regime can be invoked.

Whereas section 727 targets capital sums, section 720 is aimed at the situation where UK resident individual taxpayer transfers assets to a non-resident in order to avoid or to minimise their UK income tax liability, which results in income becoming payable to the person abroad.[75] By virtue of the provision, the income that arises to the non-resident is deemed to be that of the transferer and taxed as such.

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[73] See Chapter 5 para 5 3 1 3.
[74] See Chapter 5 para 5 3 3 3.
[75] See Chapter 5 para 5 3 3 2.

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In the case of Belgium, by virtue of the Cayman tax regime, all accumulated trust income that is subsequently distributed to a Belgium resident founder or beneficiary is deemed to be dividends and treated as such for tax purposes.

Although the Cayman tax regime applies to qualifying legal arrangements that are used to avoid Belgium income tax, it is not the legal arrangement itself that is the taxable person for purposes of the Cayman tax.[76] Consequently, for the operation of the Cayman tax regime, one must be able to identify a taxpayer to whom the income of a legal arrangement is attributed and who bears the reporting obligations. Once identified, these taxpayers are regarded as the taxable parties and will be responsible for all tax duties of said arrangement.

In light of the above, it is evident that the different jurisdictions have adopted distinct methods of addressing the same problem. Although the South African approach is not perfect, it is submitted that it is preferred above that of the other jurisdictions.

Unlike the UK and Belgium, South Africa only imposes income tax on the capital distribution made to the beneficiary from the non-resident trust. The distribution does not trigger an ongoing tax liability. Similarly, if section 7(8) is applicable, the tax liability will continue until the operation ceases. This can occur if the causal link has been broken or at the death of said donor. It is submitted that the UK's consequences for using non-resident trusts are disproportionate to the tax benefit achieved. This is also the case for Belgium, especially considering, in most instances, there is no way for the founder to terminate such a designation.

Furthermore, since South Africa uses single SAARs, the result is a much simpler system. While South Africa may not have specific provisions for almost every type of eventuality, the general framework is broad enough to cover most variations and permutations. It is submitted that although the UK has by far the most comprehensive set of SAARs, the vast complexity and interconnected nature of the provisions make it virtually unworkable. It is unlikely that a normal taxpayer will be able to ascertain his tax liability with a reasonable level of certainty. Conversely, Belgium has an effective regime, but the poorly drafted provisions and blanket nature are unfortunate.

While several aspects of the South African provisions are still ambiguous, and the exact ambits unknown, the overall measures are fairly effective.

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[76] See Chapter 5 para 5 4 1.

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6 9 2 Income splitting

Taxpayers often use income-splitting arrangements to avoid or minimise their tax liability.[77] Such arrangements can take various forms, but the underlying rationale remains the same. In such a scenario, a taxpayer will either transfer income-producing assets to someone who is not liable to tax or someone in a lower tax bracket than the transferer.

Across all the jurisdictions, such arrangements are most prominent with taxpayers that use their spouses or minor children, but the permutations are not limited to the aforesaid parties. Thus, the income derived from the asset will be subject to less tax than would have been the case before the arrangement. For the purpose of such arrangements, trusts are widely used. In addition, in most of these arrangements, the income-generating asset is transferred to the trust without due consideration.[78]

In the case of South Africa, section 7(2) is aimed at income-splitting arrangements between spouses. In contrast, in the UK, there is no exclusive provision that targets arrangements involving spouses and the general provisions of the settlor-interested trust regime will instead catch such arrangements.

Section 7(2) aims to prevent taxpayers from transferring income-producing assets to the other spouse that falls on a lower tax band or by awarding excessive remuneration to a spouse from the trade operations of the other spouse. By virtue of the provision, the income that arises from the donation will be deemed to be that of the donor spouse and taxed accordingly in that spouse's hands.[79]

In the UK, section 624 is aimed at the situation where the settlor retains an interest in the property, but the income of said property is paid to someone else. If the spouse can benefit from the settlement, such arrangement will constitute an interest in property for purposes of the settlor charging provisions and will hence be governed by section 624. By virtue of the application, the tax treatment of the income arising under the settlement is exactly the same as if the settlor retained said assets in direct ownership.[80]

Under Belgium law, no specific provisions target such scenarios, but such arrangements will fall within the ambit of the Cayman tax regime. If a Belgium resident

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[77] See Chapter 5 para 5 5.
[78] See Chapter 5 para 5 5.
[79] See Chapter 5 para 5 2 2 1.
[80] See Chapter 5 para 5 3 1 3.

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taxpayer transfer income-generating assets to a non-resident trust, the transferer will be designated as a founder. This means that all income the trust receives will be deemed that of the founder and taxed in the founder's hands. This tax liability can even be passed on to the founder's heirs unless they reject the entire inheritance.

Based on the above, all three jurisdictions have measures in place to limit income-splitting arrangements between spouses. However, the operation and consequences of the SAARs across the three jurisdictions differ. In South Africa, it is only the income that is received by or that accrues to the recipient spouse in consequence of the donation, which is deemed to be that of the donating spouse. This contrasts with the UK and Belgium. In the former, all the trust's income is deemed to be that of the settlor until the causal connection has been severed. While in Belgium, it is also all the trust income, but the capacity of the founder cannot be relinquished. In such a case, the only option is to terminate the trust.

In South Africa, section 7(2) only applies to income accrued by reason of a donation, settlement or other disposition. Similarly, in the UK, a settlor will only have an interest in a property if there is some element of bounty present. Thus, in these jurisdictions, commercial transactions or arrangements at arm's length falls outside the ambit of the SAARs. In the case of the Belgium Cayman tax regime, the position is not so clear.

Aside from the above scenario, it is also common for taxpayers to use their minor children in such arrangements. Both South Africa and the UK have specific SAARs to address such variation. Under the Belgium Cayman tax regime, such an arrangement will be treated the same as the previous example.

In South Africa, Section 7(3) is aimed at preventing income splitting between parents and their minor children. By applying this subsection, income produced by the asset after the donation of said asset will be deemed that of the donor and taxed accordingly in the donor's hands.

Conversely, in the UK, such arrangements will trigger the effect of section 629 of the settlor-interested trust regime. If the provision applies, it deems the income that arises under the settlement to be that of the settlor parent. Thus, for tax purposes, the settlor is treated as if the settlor has received said income directly, even though the income had been received by or accrued to the minor or had been expended or accumulated for the child's benefit.

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In both South Africa and the UK, the ambit of the respective provisions is almost identical. Both provisions exclude a grandchild from the operation of the provision. The effect of both sections 7(3) and 629 is to deem the minor child's income to be that of the parent donor or parent settlor. However, under South African law, the income that is deemed to be that of the donor is limited to the income that is in consequence of the donation. In contrast, in the UK, all the income that arises under the settlement is deemed to be that of the settlor parent. But, in both jurisdictions, the provision will operate until either the minor child obtains the age of majority or until the death of the settlor, whichever event occurs first.

Although the South African approach differs somewhat from that of the UK, the result is almost identical. While Belgium has no specific provision but instead relies on the broad ambit of the Cayman tax regime. However, the UK's and Belgium's consequences are more severe.

Under South African law, while section 7(3) has the objective of preventing income splitting from occurring between the parent and the minor child, the purpose of section 7(4) is to prevent the circumvention of the anti-avoidance rule in section 7(3) through the use of a third party.[81]

This provision is aimed at the instance where a parent makes a disposition involving an appreciable element of liberality or generosity to another person, or connected party to such person, in exchange for a donation to a trust which is created for the benefit of the former's minor child. In such a case, the income arising from said donation will be deemed that of the parent.

Under UK law, there is no equivalent provision to South Africa's section 7(4), but this does not mean that such a scenario is left unabated. Based on the definition of "settlor", a person who has made with any other person a reciprocal arrangement for that other person to make or enter into a settlement will also be regarded as a settlor of the settlement. This means that the parent of the minor beneficiary will also be a settlor of the settlement even though the said parent did not create the settlement. Hence, section 629 will be applicable, and all income received under the settlement will be deemed that of the settlors and taxed accordingly. Since there is more than one settlor, the income will be attributed in equal proportions. [82]

[81] See Chapter 5 para 5 2 3 3 and 5 5.
[82] See Chapter 5 para 5 5.

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In the case of Belgium, such a reciprocal arrangement will also be caught by the Cayman tax regime. This is despite the fact that no specific provision deals with such transactions. However, pursuant to the first category of founder, any person who creates a trust will be regarded as the founder of that trust. This is regardless of who the beneficiaries are. Moreover, in the event that any person contributes assets to the trust, said person will also become a founder in accordance with the definition of the second category of founder.[83]

Thus, although the methodologies differ, in all three jurisdictions, provision is made to prevent taxpayers from circumventing the anti-avoidance provision. In South Africa, the legislature has opted to enact a separate subsection to deal with this problem, while the UK has adopted a sufficiently wide definition of settlor to also encapsulate such a scenario and hence, bring such arrangements within the ambit of the section 624 charge. Similarly, the Belgium Cayman tax regime has an equally broad ambit to also apply to such scenarios.

6 9 3 Retained interest

Sometimes taxpayers transfer assets to a trust but do not truly relinquish control over said assets. This can manifest through a number of permutations, but usually by the founder reserving certain powers or where the founder of the trust can also benefit under the trust.

Under South African law, section 7(5) targets a situation where a person transfers assets to a trust without due consideration received but where the person makes the receipt of the income conditional.[84] In other words, the receipt of the income is postponed or restricted subject to the occurrence of a specific event. This means that the income cannot immediately be distributed to the beneficiaries but will rather be accumulated until the conditions are fulfilled. Pursuant to the provision, such income is deemed to be that of the person who imposed the conditions and will accordingly be taxed in said person's hands. The operation of the provision will only cease at the death of the donor, or at the realisation of the event, whichever eventuality occurs first.

In the case of the UK, there is no comparable provision to that of South Africa's section 7(5). In such an instance, the person who created the trust will be regarded as

[83] See Chapter 5 para 5 5.
[84] See Chapter 5 para 5 2 2 4.

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the settlor of the settlement, but whether the income that arises under the settlement can be attributed to the settlor will depend on the facts and circumstances of the case. Only if the settlor has an interest in the property can section 624 apply.[85] Ultimately, whether the receipt of the income is conditional on the realisation of a specified event has no bearing on the settlor's tax liability.

Similarly, under Belgium law, the person who created the trust and the person who contributed assets to the trust will constitute founders, but whether or not the receipt of the income is conditional has no impact on the operation of the transparency framework.[86]

In light of the above, it is submitted that the rationale for South Africa's section 7(5) is unclear. It can only be presumed that the revenue authority sought to discourage taxpayers from donating their assets, where the beneficiaries' receipt is postponed. Thus, the donation is not unconditional. Following this line of reasoning, it is assumed that donations were envisaged to be absolute. One possible explanation for the provision is that since the taxpayer has the power to dictate under what circumstances the beneficiaries can receive the income, the tax liability should lie with the taxpayer. In some instances, it may be that the donor has a level of control over the realisation of the event, but in most cases, the fulfilment of the condition will be uncertain. However, it is questionable whether such a provision is required, especially considering the range of ambiguous terms and the number of unresolved problems.

Whereas section 7(5) targets a situation where a donor transfers assets to a trust but limits the beneficiaries' receipt of the income until the realisation of a specified event, South Africa's section 7(6) is aimed at the situation where a donor disposes of his income-producing assets to a trust but reserves the right to revoke the donation unilaterally or to confer the benefits of said donation upon someone else. This means that an act of revocation by the donor is envisaged. Under such circumstances, for the duration that the donor retains these powers, all income received by or accrued to the specified beneficiaries is deemed to be that of the donor and, thus, taxed in the donor's hands.

However, as with section 7(5), there is no equivalent standalone SAAR to South Africa's section 7(6) under UK law. Instead, such arrangements will also be covered

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[85] See Chapter 5 para 5 3 1 1.
[86] See Chapter 5 para 5 5.

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by the operation of section 624.[87] Under such circumstances, if the settlor has a right of revocation, such power will constitute an interest in the property. Therefore, the income that arises under the settlement will be deemed to be that of the settlor and taxed as such.

In Belgium, there is no comparable provision to South Africa's section 7(6). Instead, the Cayman tax will apply if a person constitutes a founder. The terms of the trust deed are irrelevant in calculating the founder's tax liability.

In both the UK and South Africa, the operation of the SAAR will only cease at the death of the settlor or donor, respectively. The only other circumstances that will result in the provision to terminate is if the trust deed is amended beforehand to remove the provision or clause that grants the settlor or donor the right of revocation. [88] In contrast, in the case of Belgium, if a person is designated a founder, such a person cannot relinquish their capacity.[89] With the exception of the third category of the founder, the only option to terminate the capacity of founder is to unwind the trust.

In conclusion, it is submitted that in this context, the UK's approach is preferred above that of South Africa. Although the settlor-interested regime is fairly complex, it makes logical sense. Instead of having various provisions that only focus on a narrowly defined scenario, with each having convoluted requirements, it is better to have one principle-driven regime. However, it is questionable whether punishing founders for also being beneficiaries under the trust is justified if such practice is entirely permittable under trust law.

6 9 4 Interest-free or beneficial loans

Across the three jurisdictions, taxpayers often use interest-free or low-interest loans to finance the acquisition of an asset in a trust. Before the enactment of SAARs that target the use of trusts to avoid or minimise a taxpayer's tax liability, generally speaking, such practice was commercially commonplace, entirely compliant with the law, and incurred very few adverse fiscal consequences. Using interest-free or low-interest loans, it was possible to avoid potential estate duty or inheritance tax and donation or gift taxes, if applicable in the jurisdiction.

[87] See Chapter 5 para 5 5.
[88] See Chapter 2 para 2 4 4.
[89] See Chapter 5 para 5 4 1 1 2.

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In South Africa, it is exactly this practice that the legislator addressed with the enactment of section 7C.[90] To this extent, the provision targets a person who makes an interest-free or low-interest loan to a trust. In such a case, the operation of the provision deems the foregone interest on the loan as a continual donation. This means that the donor will be liable for donations tax on the difference between the interest rate charged on the loan and the official rate of interest.

In the case of the UK, the situation is similar to many of the other scenarios discussed previously. Instead of having an explicit standalone provision that deals with interest-free or low-interest loans to trusts, both the settlor-interested trust regime and the transfer of assets regime have such a wide ambit that beneficial loan arrangements are also covered.[91]

Pertaining to interest-free and beneficial loans, the granting of the loan by the settlor to the settlement will constitute an interest in the property. Thus, section 624 will be applicable, and as a result, the income that arises under the settlement will be deemed to be that of the settlor.

In addition, if the settlor or the settlor's spouse provides a loan to the settlement, which is then subsequently repaid to the settlor, section 633 is applicable. By virtue of section 633, repayment of the loan by the trustees is treated as the payment of a capital sum to the settlor. For purposes of the provision, the term of the loan is irrelevant. This means that it makes no difference whether the loan was interest free or on fully commercial terms. In such case, the capital sum paid will be deemed to be the income of the settlor, in accordance with the attribution rules.[92]

Alternatively, if the transfer of assets regime is applicable, the transaction may give rise to the charge on capital sums. If a person abroad lends to a UK resident individual, the receipt of the loan amount constitutes a capital sum. Similarly, if a UK resident individual provides a loan to a non-resident, the repayment of such loan will be regarded as a capital sum in the resident individual's hands. Provided that all the other requirements are complied with, the provision takes income which has become payable to persons abroad as a result of the transfer and deems that income to be that of the individual.

[90] See Chapter 5 para 5 2 3.
[91] See Chapter 5 para 5 3 1 1.
[92] See Chapter 5 para 5 3 1 3.

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Equally, depending on the circumstances, it is possible that section 731 can also apply where interest-free or beneficial loans are concerned.[93] However, it is considered that if the loan is on commercial terms, there is no benefit for tax purposes. Only if the loan is provided on favourable terms or if the outstanding liability is subsequently waived will it give rise to a chargeable benefit. In such a case, the value of the benefit is not the face value of the debt waived but the market value.

Thus, a beneficial loan will constitute a benefit for tax purposes. A beneficial loan can either take the form of an interest-free loan, a low-interest loan or a loan that is on more favourable terms than what can be obtained in the open market. In such a case, the value of the benefit is equal to the official rate of interest on the outstanding loan amount. If interest is levied on the loan, the benefit is limited to the difference between the rate of interest actually charged and the official rate of interest.

In contrast, under the Belgium Cayman tax regime, no specific provision deals with interest-free or beneficial loan arrangements. However, since the Cayman tax regime can apply to both bountiful arrangements and transactions for consideration, an interest-free or beneficial loan will also be covered. Thus, in such case, the person who makes the trust loan will be designated as a founder. This means that all the income that arises to the trust will be deemed to be directly received by the founder and taxed accordingly in the founder's hands.[94]

Based on the above, it is clear that all three jurisdictions have some form of protection against using interest-free or low-interest loans to trusts. In South Africa, this is achieved by a combination of section 7 and section 7C. By virtue of these provisions, an interest-free or beneficial loan can attract both donations tax and income tax consequences. In the UK, such arrangements are also included in the ambits of the settlor charging provisions and the transfer of assets regime. Due to the nature of the regimes, the ambits are much wider than merely interest-free or low-interest loans but nevertheless apply in such circumstances as well. Regardless of the provision applicable, the operation of said provision gives rise to an income tax charge. However, the multitude of potentially applicable provisions makes the determination incredibly complicated. The ambit of section 633 is unjustly wide that even commercial loans will be covered. Finally, the duration of the tax liability imposed is not justifiable.

[93] See Chapter 5 para 53 3 4.
[94] See Chapter 5 para 5 5.

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Conversely, the Belgium Cayman tax regime is also defined wide enough to cover loan arrangements. But in this case, the existence of the interest-free or beneficial loan merely triggers the "founder" definition, which then invokes the greater Cayman tax regime.

It is submitted that although the ambit of South Africa's section 7C is too wide, it is preferred above that of the other jurisdictions. However, it is questionable whether such SAAR is even needed.

6 9 5 Benefits received

Aside from the scenarios discussed, the UK further has SAARs that levy a tax charge on benefits received. Unlike the other jurisdictions, this charge extends to benefits received, which is not the receipt of money. However, the benefit must still have a monetary value that must be ascertainable. Depending on the circumstances, such arrangements can either be covered by:

1. the transfer of assets regime;[95] or
2. the protective trust regime.[96]

In contrast, in South Africa and Belgium, there are no equivalent provisions to that of the UK. In South Africa, the SAARs discussed mainly refer to an amount. Thus, it is possible for such benefits to also fall within the ambit of these provisions. However, it is doubtful if this is applied in such a way in practice. It is unlikely that taxpayers will declare such benefits to the revenue authority. While in Belgium, the Cayman tax regime only speaks of income received by a qualifying construct. Therefore, it is unlikely that an arrangement that gives rise to a benefit other than the receipt of money will be covered.

Notwithstanding the above, it is submitted that such SAAR is unnecessary. The complexity and high administrative burden associated with such provisions diminish any benefit. Hence, it is not surprising that these SAARs in the UK are seldom applied in practice.

[95] See Chpater 5 para 5 3 2.
[96] See Chapter 5 para 5 3 3 4.

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6 10 Rethinking the fundamentals

The current approach to anti-avoidance provisions can largely be described as reactionary in nature. As certain loopholes emerge in legislation, the affected provisions are either amended to close the gap or new provisions enacted to target the new variation or type of arrangement specifically. This means that revenue authorities often start on the back foot. Notwithstanding, this interaction between revenue authorities and taxpayers can most accurately be defined as a cat-and-mouse relationship.

Even if a jurisdiction has a range of SAARs, the success rates achieved are often mixed. While numerous factors may contribute to the fluctuating results, an important indicator is the quality of the legislation.

It is submitted that the loopholes usually stem from poorly drafted legislation, which often includes one or more of the following:

1. poorly defined purpose;
2. ambiguous terms;
3. unclear ambit;
4. over complicated requirements; and
5. contradictive and incoherent provisions.

While the objective may be to improve the overall effectiveness of the anti-avoidance provisions, the side effect of the continual amendments may actually exacerbate the situation. This can be explained by the notion that by frequently patching provisions, the overall result is diminished. Such practice can also inadvertently create future problems, which will require further amendments to rectify, thereby causing an infinite cycle. Even though the amendments may fulfil the stated objective, the end result is often a more complicated and disjointed piece of legislation, which ultimately reduces certainty and compliance. Thus, it begs the question of whether such a backwards-facing approach is still suitable.

It is submitted that for a SAAR to be effective, two elements need to be present:

1. deterrent; and
2. implementation.

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First, the existence of a SAAR arguably already acts as a deterrent for taxpayers not to make use of such an arrangement. This is regardless of whether the SAAR is eventually invoked or not. But there is a caveat, which is two-fold, taxpayers must be aware of the SAAR, and the consequences should be severe enough. However, the notion of deterrence is also closely correlated with the integrity of the revenue authority. This means there is an inverse relationship between the deterrence factor and the revenue authority's reputation. Put differently, regardless of the quality of the SAARs, the deterrence objective will not be achieved without a credible revenue authority. If taxpayers know that certain provisions are only there for show but are seldom enforced, or even if said provisions are relied on, the success rate is so low the deterrent factor is severely eroded. Thus, the mere existence of a SAAR is not enough, it must be followed by successful implementation.

Although the integrity of the revenue authority hinges on various aspects, the enforceability of legislation is an important consideration. As a point of departure, SAARs are inherently complex due to their highly specialised and technical nature. However, it is submitted that the most successful SAARs strike a balance between thoroughness and complexity. Thus, such SAARs are specific enough to be clear and understandable while being general enough to apply to different permutations. But, it is submitted that this is unfortunately seldomly achieved. If there is a disconnect between the tax revenue collected by applying the SAAR and the cost to administer such a provision, it is questionable whether such measures should be retained.

In light of the above, it is not surprising that jurisdictions such as Mauritius have completely abandoned the notion of SAARs. Instead, Mauritius has liberalised and modernised its tax and trust legislation. Collectively these changes have enabled Mauritius to become the preferred investment destination in Africa. In this case, it is evident that a total abolishment of all SAARs yielded excellent results for the country, but this will not necessarily apply equally to all jurisdictions. Thus, it is submitted that under certain conditions, it may be of more benefit to do away with SAARs completely. However, such a drastic departure may not be palatable for all jurisdictions.

6 11 An alternative approach; sweetening the deal

Instead of revenue authorities trying to outsmart taxpayers with swift amendments, or relying on complicated SAARs, or threatening taxpayers into submission, an argument

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can be made to change the underlying relationship. However, for this to work, it will require a new way of thinking by both parties.

The author's aim is not to merely provide technical recommendations that will only lead to changes within an already complex system of taxation but rather to introduce a new policy approach to the taxation of trusts.

Before one can discuss the new compact, it is worthwhile to revisit some of the basic principles of taxation. Only if one is reminded of the original terms of the agreement can one start to envisage a way forward.

Taxation can be described as a social contract between citizens and the state. It is an implicit reciprocal agreement where the citizens agree to pay their fair share of taxes in exchange for the delivery of services by the state. The overarching guideline to any expenditure by government must always be whether it is in the best interest of the people. If either party breaches their side of the agreement, the functioning of the system is jeopardised. This typically occurs when citizens engage in tax avoidance or tax evasion practices. In terms of the state, a breach occurs when resources are wasted.

Compliance with tax legislation is determined by tax legitimacy and the perception of fairness among citizens. This is closely related to broader government legitimacy. Factors such as efficiency and equity of allocation of funds, clean and honest governance and level of corruption can further have an impact on the latter. There is a strong correlation between the level of tax morale and the level of non-compliance with tax legislation. The lower the morale, the higher the incentive for minimising tax liability. A broad range of factors will influence a country's tax morale. The most noteworthy typically relates to the level of satisfaction with the controlling government and how taxpayers' money is used. This is comprised of economic, social and political aspects. It may include the levels of economic growth, corruption, malmanagement, unemployment, poverty, social ills and the efficiency of State-owned enterprises.

In light of the above, many may argue that the South African state has failed its taxpayers. One does not have to look far for countless examples. From this perspective, it is not surprising that taxpayers are reluctant to pay their taxes. Instead, taxpayers are finding creative ways to reduce their tax liability. However, this may be understandable for some; it does not constitute a legal justification.

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Although an in-depth discussion of tax morale falls outside the ambit of this dissertation, one cannot simply disregard it when considering South Africa's unique context and challenges. It remains an important factor to consider when crafting a South African income tax regime in respect of trusts that will encourage investment, limit tax avoidance and curb capital outflows.

With the aforesaid as background, it is clear that a different approach is required. Since tax morale is in the doldrums, the fight against tax avoidance will not be won by simply enacting more SAARs or merely criminalising unwanted activities. Instead, the root cause of the problem needs to be addressed.

One way this can possibly be done is by creating a new social compact between the revenue authority and taxpayers. According to the DTC, the role of the tax system and the role of the state is intertwined. Thus, why not make the taxpayers part of the solution to assist the South African state in fulfilling services to the people while complying with international obligations and good practice guidelines?

While tax avoidance can manifest in many ways, the use of trusts has been repeatedly flagged as facilitating such practices. This is despite the fact that the trust structure was never intended for such uses. Notwithstanding, the same characteristics that make trusts so appealing also cause great difficulties for revenue authorities. However, not all trust types are problematic.

The biggest challenge for revenue authorities lies with discretionary trusts. Unlike in the case of vested trusts, the beneficiaries of a discretionary trust are not absolute but can rather be elected from a predefined class of beneficiaries. This makes it more difficult for revenue authorities to ascertain in whose hands the trust income must be taxed. Complicating matters even further is the notion that trustees can use their discretion whether or not to make any trust distributions. Thus, not only is it uncertain which beneficiary may receive a distribution, but also whether any distribution will be made. In addition, practical considerations such as the timing of distributions should also be considered.

In order to determine a beneficiary's tax assessment, the revenue authority relies on information submitted by the trustees and beneficiaries. But often, beneficiaries do not disclose trust distributions in their tax returns. The DTC also flagged this lack of compliance by taxpayers as a major concern. Those parties opposed to trusts may argue that the opaque nature of trusts enables such conduct. Notwithstanding, the challenge is further exacerbated by the limited information available on trust parties.

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Although it is a requirement under South African law that a copy of the trust deed must be lodged with the Master, there is no way to check whether a taxpayer is a beneficiary under a trust. Thus, it is very difficult for the revenue authority to verify a beneficiary's tax return. Unsurprisingly, it was recently proposed that third parties must start collecting and reporting on trust distributions.[97] However, it is submitted that such a solution on its own merely treats the symptom. It further raises various questions pertaining to the privacy of the trust parties.

However, none of the above challenges would be relevant if the revenue authority had the trust and co-operation of taxpayers. Thus, if there is no reason for taxpayers to use trusts for tax avoidance arrangements, there will also be no need for complicated SAARs. If this notion is true, it renders the debate on what is the best form for a SAAR redundant. But the logical question is how can this be achieved?

For such a system to be successful, the proposed taxation framework for trusts must be appealing enough to first entice investors and second to remove taxpayers' desire to resort to avoidance arrangements. In other words, the tax framework should not just be clear, but the level of taxation should be perceived as being fair. However, such a system should also satisfy the revenue authority's need for accurate information.

All factors considered, it is submitted that South Africa should adopt a tiered-based tax framework for trusts. Under such construction, the applicable tax rate will depend on the amount of information that is disclosed. Thus, taxpayers are rewarded with a reduced tax rate in exchange for disclosing information. The information disclosed can possibly include any of the following, but are not limited to the below:

1. personal particulars of all parties;
2. trust documents;
3. meeting minutes;
4. accounting records;
5. bank statements; and
6. financial statements.

[97] A Visser "Third party reporting on trust distributions in its way" (04-10-2022) *Moneyweb* <https://www.moneyweb.co.za/mymoney/moneyweb-tax/third-party-reporting-on-trust-distributions-on-its-way/> (accessed 22-12-2022).

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While such a tiered-based framework can potentially be extended to also apply to companies and other entity types, it is submitted that the full benefit will only be achieved in the context of trusts. This can be explained by the notion that the tax challenges with trusts are not shared with other entity types. Instead, the challenges stem from the unique legal nature of a trust. First, trust income can be taxed at different levels depending on the circumstances. This means that it is not always the trust that is the taxable party; instead, it can be any party in the trust relationship. Furthermore, trust information is private and not publicly available. This is in contrast to companies, where various information can be obtained from public sources.

Although the reduced tax rates may appear to be detrimental to the amount of revenue collected, it is submitted that any reduction is likely to be negligible. Instead, it is more probable that the revenue will increase. Evidence for this premise can be found in the Laffer curve theory. The Laffer curve purports to show that the total tax revenue may rise even when tax rates decrease. More specifically, this phenomenon is explained by the so-called economic effect, which recognises that tax revenues increase/decrease in the exact opposite direction of the change in tax rates.[98] In other words, this effect contributes to how raising taxes decreases revenue and lowering taxes increases revenue. Since an overwhelming number of trusts are currently not compliant, it stands to reason that currently, only a fraction of taxes due are actually collected. Thus, even with lower tax rates, if the majority of trusts comply with their obligations, it is submitted that the tax revenue could be substantially higher. Moreover, it is likely that the costs and administrative burden associated with collecting the revenue from trusts could drastically reduce, which will offset any foregone revenue.

However, the success of such a system hinges on the quality of the data collected. One possible way to provide a reasonable level of assurance is to ensure that the information is correlated from and cross-checked against a wide range of sources. This means that the revenue authority will rely on not only third parties but also taxpayers themselves. However, the primary source of information should remain the taxpayers. The third parties' submissions should mainly be used to supplement taxpayer data and check accuracy. This will enable the revenue authority to objectively

[98] AB Laffer "The Laffer Curve: Past, present and future" (01-06-2004) *Backgrounder* <https://iife.edu.vn/wp-content/uploads/2020/04/Laffer-Couver-Last-Present-and-Future-bg1765.pdf> (accessed 22-12-2022).

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verify all information provided. Furthermore, the system should be robust enough to limit the likelihood of abuse.

It is submitted that it should also be required to lodge a copy of the trust instrument with the revenue authority when the trust is registered. This will ensure that the revenue authority is aware of the parties to the trust from the trust's inception. Moreover, a joint responsibility could be placed on professional practitioners and the Master to notify the revenue authority if a change of particulars occurs.

Aside from relying on third parties to report on taxpayers, all parties to a trust must be required to disclose such a relationship in their tax returns. This disclosure should not just include taxpayers' relationship with South African resident trusts but also with non-resident trusts. All the relevant documentation must accompany this. The trust must further provide a full report on any distributions made during the year of assessment. Conversely, the beneficiaries must report any distribution received.

However, to ensure that taxpayers accurately declare their interests in non-resident trusts, the revenue authority should invoke the mechanisms available under the automatic exchange of information and the common reporting standard framework. This will enable the revenue authority to verify those submissions objectively and detect any attempts to hide offshore income.

This means that South African residents who are beneficiaries under a Mauritian trust, or any other non-resident trust, will be unable to conceal the distributions made by the non-resident trust. Even if such distributions are not repatriated to South Africa but instead kept in a Mauritian bank account, the revenue authority will be able to assess the taxpayer on said income and tax it accordingly, subject to any double tax agreements between the jurisdictions.

Only once all the information is successfully verified will the taxpayer benefit from the preferential tax rate. It is submitted that such a system should leverage technology and that this process should largely be automated. Hence, manual intervention should be reserved for the difficult cases.

In many ways, the above disclosure requirements are similar to the reporting requirements under the Belgium Cayman tax regime. While it could be argued that it places an added burden on taxpayers, it is submitted that it is a justifiable compromise in order to offer competitive tax rates safely. It is further submitted that the burden will be negligible for well-managed trusts and honest taxpayers. However, for those parties who would like to keep their tax affairs concealed, the favourable tax rates may not be

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sufficient to entice such parties to use a South African trust for investments. But it is submitted that South Africa is better off without such investors.

While favourable tax rates mean that taxpayers are less likely to revert to avoidance arrangements, there may always be the few that try their luck. Thus, one measure that can be used to prevent such conduct is that the failure to disclose trust-related information should be met with harsh punishments.

First, non-complying taxpayers should be subjected to a punitive tax rate. This can be in conjunction with more traditional measures, which may include financial penalties and criminal prosecution. However, it is submitted that the revenue authority should also have a voluntary disclosure initiative available. Such a programme should give those taxpayers whose tax affairs are not compliant the opportunity to regularise their affairs without the risk of attracting criminal liability. Nevertheless, such amnesty should only be available once per taxpayer and must be subject to the condition that the taxpayer is open and honest.

Moreover, there is a strong argument to be made that not only the offending taxpayers should be punished, but also their advisers. This means that those tax practitioners who facilitate unwanted activities should also be sanctioned.

With all the data at their disposal, revenue authorities can use the information to assign a risk score to each taxpayer.[99] It is submitted that to utilise all this data optimally, the revenue authority should leverage the power of artificial intelligence ("AI") and machine learning. The main objectives of such a risk score are twofold: to manage the assignment of the limited resources available, and to determine the applicable tax rate for the taxpayer. Hence, one can describe this risk score as a form of a "trust score".

Thus, such a trust score can be equated to a person's credit score, which is used to assess a person's risk profile before credit is granted. Similarly, as a person's credit

[99] Such risk grading system can further assist South Africa with complying with the Financial Action Task Force's ("FATF") recommendations. Since South Africa is currently facing the threat of being grey listed, it is evident that the current measures are wholly inadequate. The FATF has flagged amongst others, the regulation of trusts, monitoring financial transactions, compliance with anti-money laundering legislation, and enhancing the disclosure of trans-border cash transfers. Financial Action TASK team "Anti-money laundering and combatting the financing of terrorism" <https://www.fatf-gafi.org/media/fatf/documents/reports/mer/MER%20South%20Africa%20full.pdf> (accessed 22-12-2022).

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score has a bearing on the interest rate offered, a taxpayer's trust score can directly influence the tax rate afforded to the said taxpayer.

Based on the risk profile of taxpayers, it is possible for the revenue authority to direct resources where it is most required. This means the focus can be placed on those taxpayers that are considered high risk for devious activities. By applying AI and machine learning to the dataset, the revenue authority can discover non-compliance and identify emerging trends, predict possible offenders, and anticipate their future actions. Thus, a larger focus on targeted actions and preventative measures.

In calculating such a score, the revenue authority should consider various factors. This should comprise both positive and adverse data. This means that, as with a person's credit score, a taxpayer's trust score can fluctuate from one year to the next, depending on the taxpayer's behaviour.

It is submitted that the trust score calculation may include, but is not limited to, the following factors:

1. the accuracy of disclosures;
2. the level of co-operation;
3. timely submissions;
4. all tax affairs up to date;
5. any unwanted arrangements;
6. dishonest conduct;
7. the level of compliance with other legislation; and
8. any form of non-compliance.

However, this does not mean that the level of co-operation will always be indicative of illicit or unwanted activities. But it can serve as an indication of where further investigation may be appropriate. Thus, the level of disclosure can be one factor to be taken into account when selecting taxpayers for possible audits. Once again, this process can significantly be aided by the use of AI.

In addition, the conduct of the other parties in the trust relationship can also have an influence on the individual taxpayer's trust score. Thus, the trust and beneficiaries will only enjoy the best rates if everyone complies with their obligations. If the non-compliance is not so severe, the result may be that all the related taxpayers are shifted to a lower tier, which means a less favourable tax rate.

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It is submitted that the proposed tax framework should consist of five tiers. The first three tiers should be awarded for transparency and disclosure requirements, while the last two tiers could be reserved for socio-economic objectives. This means that the tax system can be utilised to achieve more than just revenue targets.

It follows that a taxpayer can be classified into one of the tiers based on said taxpayer's trust score. The trust score is a nominal value that can range between 0 and 1000. The value spectrum is divided into five categories, each representing a tier level. Thus, the tier scores will be as follows:

1. tier 1: 0 to 199;
2. tier 2: 200 to 399;
3. tier 3: 400 to 599;
4. tier 4: 600 to 799; and
5. tier 5: 800 to 1000.

It is further submitted that the tax rates should range between 45% and 15%. If a taxpayer falls within tier one, the default position should be that the trust is taxed at the marginal rate of 45%. Thus, the taxpayer will only start to reap the benefits from tier two onwards. The rates should be 35% and 25% for tier two and tier three, respectively. The final two tiers can reduce this even further and offer taxpayer rates of between 20% and 15%.

Pertaining to the socio-economic requirements, the South African government can identify the areas that require priority attention. It is submitted that it may include, but is not limited to the following:

1. job creation;
2. education;
3. healthcare;
4. renewable energy;
5. affordable housing; and
6. broad-based black economic empowerment.

For tiers 4 and 5, points can be awarded to taxpayers based on fulfilling various socio-economic objectives. It is submitted that the government must identify a range of quantifiable goals within each priority area. Thus, each socio-economic item will have a specified points allocation.

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These levels of taxation will ensure that South Africa is more attractive for investments, but without the reputational damage that is associated with tax havens. However, South Africa will still not constitute a tax haven, even with low tax rates, since the other requirements for such classification will not be met. Instead, if the proposed framework is implemented, South Africa can more accurately be described as a form of a quasi-tax haven. However, the tiered-based framework leverages the notion of tax nudging. The result is a quasi-tax haven without the negative consequences typically encountered with such regimes. Furthermore, with the lowest rate pegged at 15%, South Africa will not risk contravening the minimum rate of taxation. Moreover, it stands to reason that since the beneficial rates are not unconditional but instead subject to the disclosure of information, the risk of attracting devious characters is diminished. This position is in contrast to Mauritius and other tax haven jurisdictions, where the default rate is 15% or lower, without any material requirements.

6 12 Concluding remarks

In light of the preceding discussions, it is evident that trusts are very useful institutions, and it is regrettable that such negative perceptions of trusts have been created. Notwithstanding, the unique nature of South African trusts allows unmatched flexibility and adaptability. If trusts are applied correctly, they can address a range of circumstances and be a preferred investment vehicle. However, in order to enhance the use of trusts, it is paramount that the tax framework is supportive.

Although the possibility exists for trusts to be misused, I have proposed a new tier-based tax framework for trusts. This proposal aims to change the negative narrative on trusts and introduce a new compact between taxpayers and revenue authorities. Ultimately, the balance is between an investment-friendly regime and a responsible jurisdiction. Consequently, I hope that my proposal will be thought-provoking for policymakers and offer a fresh perspective on an extremely complicated topic. I am confident that the proposal put forward in this dissertation can positively influence South Africa’s tax policy on trusts and lay the foundation to start building a better South Africa for all its people.

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