

TRUSTS AND OFFSHORE TRUSTS

by

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CHAPTER 1

INTRODUCTION

1.1 TRUSTS ARE THE RIGHT WAY TO GO

ESTATE planners wanting protection from creditors and the adverse consequences of the changes in exchange control regulations should consider establishing trusts. Commercial lawyer Aaron Stanger said South Africans contemplating emigration should consider establishing trusts to prevent their assets from being frozen in the event of further migration. Stanger was speaking at a conference on trusts and estate planning in Johannesburg on 13 February 2002. He said complicated and expensive estate procedures could be avoided through trusts, and that they were unique for planning tax, estate duty and capital gains tax. Stanger said that “with the unrelenting assault of the fiscus on the SA taxpayer and capital gains tax to be recovered from the wealthy, trusts have become an important vehicle for protecting one’s “hardearned wealth”. Stanger said that trusts were taxed on 50% of their gain, at 32% on the first R100 000 and 42% on all amounts greater than R100 000. Companies on the other hand were taxed on 50% of the capital gain at the company tax rate. Individuals were taxed on 25% of their gain at their marginal tax rate. He said that the first R10 000 of taxpayers’ capital gains tax or losses were exempt. “Capital gains tax is triggered automatically by death”, he said. He said recent changes had been made in the estate duty and donations tax rates. The rate for

estate duty had been changed from 25% to 20%. The rate for donations tax had been changed from 25% to 20%. Stanger said taxpayers embarking on transferring property out of companies, close corporations and trusts into their own names to qualify for the R1m exemption, “should take a number of considerations into account before doing so”. The tax laws made provision for a R1m exemption on the disposal of residential property held in the name of individuals. The exemption did not apply to property held by trusts, companies and close corporations, Stanger said. Taxpayers would qualify for the exemption on the first R1m of the gain attributable to the primary residence. Such taxpayers would only “make a tax saving of R100 000”. Stanger said they should have regard to the “other multi uses of trusts” before transferring property back into their own names. These included the protection trusts offered estate planners from creditors, benefits of privacy, multiple ownership of assets and income tax splitting, he said. High-risk professionals, such as self-employed people should take these factors into account, he said. SA had moved to a “fully capital transfer and wealth tax system”, Stanger said.

1.2 POWER OF TRUSTS

Henry Ford II left the bulk of his fortune, estimated at \$250 million, to a private trust whose beneficiaries are unnamed according to his will...

The New York Times, Wednesday, October 7, 1987

Upon the death of Mayor Richard Daley of Chicago, Illinois, it was learned that much of

his assets were put into family trusts after a 1974 stroke. That would put most of his holdings in the hands of his wife or seven children with no public disclosure!!

Combined Wire Services, Chicago Tribune

Mesabi Iron Company received a ruling from the Commissioner of the IRS allowing them to transfer all of their assets into trusts so that they would not be taxed as corporations. The effect of the ruling is that the trusts themselves were non-taxable.

Wall Street Journal, March 13, 1961

Rupert Murdoch transferred Boston TV Station WFXT into an independent trust to avoid cross-ownership laws that would have put the TV station at risk.

Wall Street Journal

1.3 PROBATE EXAMPLES WITHOUT THE USE OF TRUSTS

Mr A Deeds, Chairman NCR of Dayton, Ohio, gross estate of \$13,312,905.00. Total cost and taxes at time of death, \$7,902,005 reducing his estate by 58%!!

Albert H. Wiggin, retired Chairman, Chase National Bank of New York City, New York, gross estate of \$20,493,990,00. Total cost and taxes at time of death, \$14,865,310.00 reducing his estate by 72%!!

1.4

ADDITIONAL EXAMPLES OF THE POWER OF TRUSTS

Ronald Reagan established the “Ronald Reagan Trust” in 1966 enabling him to receive sizeable tax advantages. In some years Mr Reagan paid no taxes at all while at the same time maintaining a magnificent lifestyle.

H.L. Hunt, the Texas Oil Billionaire, is reported to have paid \$75 000 for the setting up of the first Hunt Family Pure Trust. Today it is estimated the family uses 200 or more Trusts.

Joseph Kennedy, father of John F. Kennedy, used many Pure Trusts for his family and various businesses.

CHAPTER 2

THE NATURE OF TRUSTS

2.1 WHAT IS A TRUST?

A Trust is a legally acknowledged and binding arrangement whereby a person (or a number of people), known as the Trustee or Trustees, become the legal owner(s) of assets transferred to them by a Settlor or Settlers but only in as much as they are holding those assets for the benefit of another person or people, known as the Beneficiary or Beneficiaries.

The assets which are placed into a trust are called Trust Properties and can include anything which can be legally transferred such as:-

- Cash
- Securities
- Property
- Boats
- Cars
- Antiques
- Copyrights
- Land

- Pension Funds
- Complete Companies

In our experience, cash (bank accounts), property and trading companies are the three most common assets to be placed in offshore trusts, for obvious reasons.

Although a trust can be a verbal agreement and implied by law, i.e., your words and actions are legally acknowledged by previous, similar precedents, it is far more common for a trust to be established by way of a written document called either a Deed of Trust or Declaration of Trust. This document describes the trust and details how it is to be administered and for whose benefit.

The person giving assets to a trust is known as the Settlor and is commonly named in the Trust Deed, but, depending upon the jurisdiction where the trust was established, not necessarily so. It is therefore quite possible to give assets to a trust anonymously (in the sense that you don't want to be linked as having given your assets to 'your' trust). This feature of certain trusts is regarded by many as one of the most valuable, if implemented correctly it can enable someone to appear to be of only modest means, yet live a luxurious lifestyle, the 'trappings of wealth' all belonging (ultimately) to a trust with no legal connection to that person. Great care must be taken in such instances since otherwise tax authorities tend to 'see through' the trust and tax you accordingly – it can be mighty hard to disprove such a 'connection' with a trust!

When either periodic or terminal payments are made from a trust to either a person or people named in the Trust Deed, the recipient(s) are known as Beneficiaries, i.e., they benefit from the trust.

2.2 BACKGROUND AND HISTORY

Most countries have one or other of two basis for their laws, either **CIVIL** law, historically derived from an early Roman concept, or **COMMON** law, derived from an early English concept where trusts can be traced back as far as medieval times.

In countries where civil law rules, trusts are either very uncommon or are not legally recognized, thus making Offshore Trusts of great importance in tax avoidance and asset protection to residents in those countries. Common law countries recognized trusts quite freely, indeed many trusts are established 'onshore' for asset protection or inheritance purposes. However Offshore Trusts still play a significant part as far as residents of **common** law countries are concerned, for they are ideal vehicles for tax avoidance.

Offshore countries, with their liberal taxation laws and strict non-disclosure arrangements (usually by way of not even knowing) are ideal bases for trusts of all kinds. Some offshore jurisdictions will allow nominee Trustees, will allow assets to be settled into a trust after it is formed to protect the identity of the Settlor and the type and value of the assets placed in trust, will allow trusts to have an indefinite life (most jurisdictions insist

on a specific life span for a trust) and will allow beneficiaries to be un-named and left to the discretion of the Trustees (see next section). Indeed it is not unknown for some enlightened jurisdictions to ensure that their laws over-ride the laws of the Settlor's and/or Beneficiaries' country in any trust matters.

2.3 TYPES OF TRUSTS

2.3.1 BENEFICIAL TRUSTS

A Beneficial Trust is one in which the Beneficiaries are specifically named in the trust document, i.e., 'John Smith will receive the sum of US \$100 000 on his 25th birthday'. Whilst beneficial trusts can be of value for asset protection and perhaps inheritance tax purposes, because there is a specifically named beneficiary (or several), they are all but useless for tax planning and privacy purposes, the Revenue Authorities in the country of residence of the beneficiary will soon become aware of the 'inheritance'.

2.3.2 DISCRETIONARY TRUSTS

If a beneficiary is named in a trust document, or if the beneficiary is clearly also the Settlor, Revenue Authorities tend to 'look through' such trust arrangements and regard the beneficiaries as the owners of the trust assets and income. Thus it is quite feasible

that beneficiaries can be taxed on assets or income which they never own or receive – simply on the basis that they *could be* the owner!

To get around this problem, what are called Discretionary Trusts were established. These are arrangements where the actual beneficiaries of the trust are at the absolute discretion of the trustees. Since no specific beneficiaries are named in the trust document, revenue authorities cannot tax any potential beneficiaries since there is no way of knowing when, or even if, they will benefit from the trust, although tax is (in theory) payable on the receipt of the proceeds of the trust by a specific beneficiary. But you wouldn't be so foolish as to have any distributions from the trust made over directly to you anyway would you? Do so via an offshore account or via an offshore company linked to the trust. We will advise fully on such structures, including ideas such as using credit/debit cards for drawing cash 'onshore' from an offshore trust.

2.3.3 OFFSHORE ASSET PROTECTION TRUSTS

An Asset Protection Trust is little more than a specific type of Discretionary Trust and, as its name implies, is generally used by either private individuals or corporations to hold their assets in a form which makes them untouchable under any court order imposed against them. Very common in the U.S.A., correctly formulated and held, Asset Protection Trusts are showing signs of resisting attacks by creditors far better than Family Limited Partnerships which are widely promoted and frequently far more expensive.

2.4 TRUST STRUCTURE AND ADMINISTRATION

A Trust, whether onshore or offshore, and of any type, has a number of component parts. In essence these are very simple and straightforward, although the Deed itself is a complex legal document and must only be written and modified by someone with detailed, in depth, understanding of the trust laws of the chosen jurisdiction. The major components of a trust (of any type) are:

* **The Settlor (Grantor)**

This is the person or entity who formulates the trust and who settles his assets into the trust.

* **Deed of Trust (Trust Document)**

This is the legal trust document itself and contains all the permutations and combinations of what the trust and its controlling Trustees can and cannot do according to both the wishes of the Settlor and the laws of the jurisdiction where the trust is written.

* **Trust Property (Assets)**

The assets which the Settlor places into the trust from time to time. Depending on the type of trust, settled assets do not need to be specified in the initial Deed of Trust but may be added later.

* **Trustee(s)**

The named individual, individuals or company appointed by the Settlor to administer his wishes according to the Deed of Trust. Frequently a professional Trust Agent within the jurisdiction of the trust, the Trustee has absolute control over the trust assets.

* **Beneficiary**

The person or persons to whom the Settlor wishes the trust assets or income thereof to be paid to according to circumstances dictated in the Deed of Trust. Depending on the type of trust, Beneficiaries do not need to be specified in the Deed of Trust, but can be made known to the Trustees privately.

* **Protector**

A Settlor can name a third-party individual to ‘oversee’ a trust to ensure that the Trustee is administering the trust according to his wishes.

* **Letter of Wishes**

A Settlor can write a Letter of Wishes alongside a Deed of Trust which spells out exactly what actions he wishes the Trustees to take under differing sets of circumstances. This Letter is totally private between Settlor and Trustee and whilst not legally binding, is an excellent guide for a Trustee to follow, especially if the Settlor is no longer in contact with the Trustee for any extended period.

Obviously for any form of trust to work efficiently and effectively and be secure, the Settlor must have absolute faith in the Trustees, otherwise a Trustee could simply run off with the trust assets, name friends and relatives as beneficiaries or invest trust assets in a totally reckless way. There are a number of safeguards in this respect and trustees worldwide will observe both written and unwritten rules:

- * **Firstly**, Trustees have to be licensed by the government to carry out trust work, and these licenses are usually only given out to highly reputable and established organizations such as lawyers or accountants – if a Trustee was ever even suspected of misconduct it would be the end of his business career.

- * **Secondly**, when a trust is established, the Settlor can prepare a ‘Memorandum of Wishes’ (‘Letter of Wishes’). This document, which may be changed at any time, expresses the Settlor’s wishes concerning the management and distribution of the trust. Whilst not legally binding, a Memorandum of Wishes is usually the major guide a Trustee has, and is usually observed to the letter unless there are over-riding considerations which prevent a Trustee doing so. In this event, (and offhand we can’t think of one), the Trustee would return to the Settlor for instructions.

- * **Thirdly**, it is also possible to appoint a Protector or Guardian to oversee a trust and control the powers exercised by the Trustees, however there are potential problems with tax authorities here, since the appointment of a protector could be

construed as a thinly veiled attempt by a Settlor to influence the Trustees to his advantage.

* **Finally**, Panama Trust laws make specific provision to allow the Settlor, under the written authority of a Power of Attorney given by the Trustees, to act effectively as a Trust Manager. This can have major advantages for a Settlor who wishes to have tight control over a Trust and is reluctant to let any Trustee have total control..... But, and it is an important but, whilst legal under Panama law, this provision is regarded by most major tax authorities as making the trust a sham and thus giving them full legal rights (in their eyes anyway) to disregard it and over-ride its provisions and protection. Having said that, this Power of Attorney is a totally private document between the Settlor and the Trustees and if used wisely and carefully can be a very valuable tool in offshore asset management.

CHAPTER 3

DEFINITIONS

3.1 THE BENEFICIARY

Any person born or unborn, natural or juristic may be a beneficiary. Where the beneficiary is a juristic person, the beneficiaries are taken to be the members in their capacity as such. They take not for their private benefit but for the purpose of the trust or association. A trustee can be the sole beneficiary but he cannot be both the sole beneficiary and trustee since there would be no element of administration for another and therefore no trust.

The founder may have been the sole beneficiary as is often the case with nominee trusts. Where the name or description of the beneficiary does not unequivocally designate to any one person or body, the court may on the evidence before it determine what was intended. In the case where income became payable upon the death of the Settlor to the beneficiary, being his wife, and where the Settlor had been divorced after the formation of the trust and subsequently remarried, the court held that the title, “wife”, was merely descriptive of the relationship, and therefore entitled the second wife to take the income on his death, ahead of the first wife, who claimed that she was “wife” at the time the trust was formed.

Where a trust is created by means of a will there is no need for acceptance in order to render a beneficiary's right indefeasible, but the beneficiary has the option of accepting or repudiating the benefit. The rejection of a right to income of the trust may result in an accrual to another beneficiary or in an acceleration of the claim beneficiary. The problem associated with an unborn beneficiary is who would act on his behalf in the case of a dishonest trustee or one who commits breach of trust. In such a case, the only solution would be the introduction of legislation to safeguard the interest of unborn beneficiaries.

3.2 RIGHTS OF THE BENEFICIARIES

Every beneficiary has the right to obtain a copy of the trust instrument and accounts of the trust administration. Rights to trust property could either be a vested or contingent right. In either case, the beneficiary still has the legal standing to ensure that the trust property is properly administered and that the trust property is not improperly alienated.

A vested right has several meanings but the following shall be examined:

- * A right vested in a person usually means that such person is the owner of that right.
- * He has all the right of ownership including the right of enjoyment.
- * It draws a distribution between what is certain and what is conditional. It is not necessary that the right vested in this sense should be ownership as it could be a personal right. Unlike a contingent right in this case the right is immediate and therefore forms an asset in the estate of the beneficiary.

* Lastly property is said to vest in a beneficiary when the capital is to be distributed, which may be later than the date on which his right to the capital is vested in the second sense.

A beneficiary's right in a discretionary trust would depend on the nature of the discretion given to trustees. In some cases, the beneficiary's right could be contingent where the trustees have the discretion whether to pay income. An advantage of a contingent right is that it does not form part of the beneficiary's estate on insolvency or for estate duty purposes.

Trustees have no real right in trust property except in the case where they are also beneficiaries. As long as the trustee retains legal ownership, the beneficiaries would be protected because of the principle that trust property forms no part of the trustee's personal estate. The beneficiaries therefore do not have to compete with the trustee's private creditors but only with the trust creditors.

S 12 of the Trust Protection Control Act (T.P.C.A) lays down in general terms that the trust property does not form part of the personal estate of the trustee. Oral trusts not reduced to writing are excluded from S 12 and are therefore governed by common law. In order to determine the trust property with certainty, statute requires that the trustee registers the trust property or make it identifiable in the best possible manner. If

immovable property is held in trust but not registered as such, it will by virtue of S 12 not form part of the trustee's personal estate.

With regards to moveable property, a beneficiary has only a right in persona, against the trustee for payment of the income or transfer of the capital due to him. In an Appellate Division case, it was held that a right to receive income from a trust fund is a personal right against the trustees and not a real right in respect of the trust assets. The beneficiary does not have a real right in respect of the trust assets. The beneficiary does therefore have an 'interest' in the trust property for the purposes of estate duty. In the situation where a trustee not merely fails to identify the trust property but mixes it with his own, the beneficiaries together with the trust and private creditors would have a proportionate claim to the net balance. The beneficiaries therefore only have partial protection if the trustee misuses the trust property with his own assets. The private creditor of a trustee may attach the trust property:

- a. if the trust is not a trust in the "strict sense"
- b. if, through a trust in the strict sense, it has not been created by a trust instrument or court order and trust property has not been registered or identified as trust property.

In the case where a trustee vacates his office he loses the ownership of any assets, which he held as trustee. The trust property does not form part of his estate and his creditors, heirs and legatees have no claim to it nor is it liable for estate duty.

The following will apply against the acquirers of trust property:

- a. The beneficiary may bring an action of delict against a third party who acquires trust property with the knowledge that such acquisition would be in breach of the trust. Steps can be taken against a third party who obtains the trust property as a result of a breach of trust or on the grounds of the so-called **doctrine of notice**. Where the trust property consists of money and this has been mixed with his personal money and loses its identity the acquirer could possibly retain ownership.
- b. The beneficiary can claim any profit made by a trustee through improper dealings with the trust property in a restitutionary action for unjust enrichment.
- c. If the trustee has mixed the trust monies with his own, the trust beneficiary cannot claim to exclude the trustee's private creditors in claiming from the mixed fund. The beneficiary is merely a concurrent creditor in respect of the mixed fund.

[Honore', Supra. Pages 87:88]

[Olivier, Supra. Pages 471:493]

3.3 DEATH OR INSOLVENCY OF A BENEFICIARY

The death or insolvency of a beneficiary does not affect a trust. What needs to be considered is whether a beneficiary with a vested interest in the trust property would con-

stitute property in the deceased or insolvent estate?

Property in a deceased estate is defined as:

“Property means any right in or to property, moveable or immovable, corporeal or incorporeal, and includes:

- a. Any fiduciary, usufructory or other like interest in property (including a right to an annuity upon property) held by the deceased immediately prior to his death;
- b. Any right to an annuity (other than a right to an annuity charged upon any property) enjoyed by the deceased immediately prior to his death, which accrued to some other person on the death of the deceased.”

*[The South African Income Tax Act No. 58 of 1962,
as amended]*

Property therefore relates to material goods or rights with respect to such goods. If a beneficiary has a vested right to the trust capital or income it would therefore constitute property in his estate and accordingly be estate dutiable.

If the beneficiary’s right to income is independent on the exercising of discretion by the trustee, there are no vested rights and it will not constitute property in his estate. He therefore has a contingent right to income and as such will not constitute property in the

beneficiary's estate. The trust instrument is the decisive factor in establishing whether the beneficiary has a vested right to the trust income or capital.

This would be determined from specific clauses in the trust instrument. Insolvency of a beneficiary is treated the same as death. Vested rights would constitute property in the insolvent estate, which can be liquidated for the benefit of creditors.

[Olivier, Supra. Page 105]

3.4 THE FOUNDER

In an inter vivos trust, the founder may reserve the right to either vary or revoke the trust during his lifetime. Similar powers could be confirmed to trustees within certain limitations. If the trustees were given the power to revoke the trust based on their discretion it would be inconsistent with the nature of a trust in that the trustee should have an entire discretion whether to execute it or not.

The founder is usually the person who initiates the creation of a trust for named or ascertainable beneficiaries. He should ensure that his wishes are properly recorded in the trust instrument and that any donated asset are clearly defined. It is advisable that provision be made in the trust instrument to revoke the trust but consideration should be made regarding income tax and donations tax implications.

3.5 REVOCATION BY THE FOUNDER

A trust however, cannot be revoked when the founder ‘irrevocably gives and donates...’

Where a donation is not irrevocable the founder cannot revoke or vary the trust without the consent of the trustee. The founder therefore retains the right to revoke a trust if the trust instrument allows that consent be obtained from trustees and trust beneficiaries who have accepted.

Beneficiaries cannot revoke a trust though they can in certain circumstances bring it to an end by demanding the transfer of the trust assets. When the parties do not purport to revoke the trust themselves, but seeks the court to do so, the consent of the founder is an element which, while not strictly necessary, will probably weigh with the court in deciding whether to exercise its powers.

3.6 THE TRUST PROPERTY CONTROL ACT

If an application is made under the TPCA to vary a trust on the grounds that circumstances have arisen which the founder did not contemplate or foresee the court might well, in order to form an opinion whether this was the case, required evidence from the founder. A trustee is entitled to apply to the court for the variation of a trust if he considers it necessary to further the trust object, for example where it is impracticable to carry out the trust as it stand. Where the beneficiaries are of full age and capacity they

can bring the trust to an end if they are entitled to the corpus of the trust property.

If they are minors or unborn beneficiaries, the consent of the court is necessary. If the beneficiaries who agree are entitled to a defined portion of the trust fund are free to set up different trusts as regards that portion, but they cannot do so if there are other potential beneficiaries interested in the whole of the trust fund.

Unlike a trustee, an executor is bound to administer the estate in terms of the will and supervision of the master. The trustee can if the beneficiaries are of full age and immediately entitled to the corpus of the trust property bring the trust to an end. The courts have no general power to alter trusts set up by will and only if the variations are minor this would be an adequate reason for the court to sanction it.

Common law powers allow the court to vary the trust to avoid frustrating the trust object or prejudicing the beneficiaries. The T.P.C.A introduces statutory powers which can be exercised when provisions in the trust instrument brings about certain undesirable consequences, such as hampering the achievement of the trust object or prejudicing the interest of beneficiaries which in the opinion of the court, the founder did not contemplate or foresee. It must be noted that in terms of S 18 of the T.P.C.A both criteria, that is the founder's lack of foresight and contemplates also prejudice to the trust object, beneficiaries or public interest must be satisfied.

[Honore', Supra. Pages 413:424]

3.7 THE TRUST INSTRUMENT

As South African common law does not confer adequate powers to the trustees for the proper administration of the trust, such powers must be drafted into the trust instrument. Possible tax consequences can be clarified by eliminating conditions that give risk to these tax problems.

An inter vivos trust is drafted in the form of an agreement because it is in essence a contract between the founder and trustees. If the founder is a relative of the beneficiary, fixed property can be conveyed to the beneficiary's free of transfer duty in terms of S 9(4)(b) of the Transfer Duty Act. It is essential that beneficiaries in whose favour the trust is created is clearly designated or that the class of persons from whom they are to be selected are clearly defined. The reason for this is that this an essential element of a trust that beneficiaries are named or ascertainable.

Although it is required that the beneficiaries are ascertained or ascertainable, it is not essential for them to be parties to the trust agreement. It is not necessary for them to sign the trust deed and they need not accept the benefits stipulated for them. The rights of beneficiaries who have not accepted the benefits stipulated for them in an inter vivos trust are somewhat uncertain.

The general view is that beneficiaries of an inter vivos trust acquires rights from the moment the trust is created and beneficiaries are deemed to have accepted the benefits stipulated for them unless it can be shown that they have renounced their benefits. The only consequence of importance attached to their acceptance is that they must be parties to any latter agreement to vary the trust document.

Beneficiaries are classified as income and capital beneficiaries. The trust instrument must also refer to the extent to which beneficiaries share in the capital and income. An unfettered discretion enabling the trustees to award income to anyone of their choice will not be valid; as such discretion will offend against the principles of a power of appointment.

3.8 VESTING DATE

Vesting date refers to the date on which the trust will be terminated and the trust property will be vested in the beneficiaries.

“Termination date” or “dissolution date” could also be substituted for the use of the word “vesting date”. There is no system for trusts as there is for companies, whereby the name of the company must be approved of before the company is incorporated.

[Olivier, Supra, Page 256]

3.9 DONATION

A nominal donation is usually made to the trustees, the reason being:

1. Donations tax will not be payable by the donee.
2. Beneficiaries of a family trust are often the founder's or estate owner's minor children. Where large sums of money are donated and which is invested the proceeds from such investment can be deemed to that of the donee and therefore taxed in his hands in terms of S 7(3) – S 7(7).

[Olivier, Supra, Page 256:257]

3.10 TRUSTEES

In the case of resignation, death or other eventualities, which may disqualify a trustee, the situation must be such that an substitute or successor can take the place of a vacating trustee. Provisions in a trust deed can therefore be varied or adapted to suit particular requirements. There are no rules regarding the number of trustees that should officiate.

Provision should also be made that a trustee whose estate is sequestrated shall cease to act in this capacity. This provision is incorporated to eliminate any arguments concerning the consequences of a trustee's insolvency, especially whether trust property forms part of his personal insolvent estate. The idea is to have a Board of Trustees of which the members are honest and do not get involved in crisis situations, which can be

embarrassing. It is practical and permissible to make provisions for a delegation of powers, during the temporary absence of a trustee. It should be stipulated that all resolutions be made by unanimous vote. Within the framework of the trust, these powers are important and necessary. Outside the official capacity as trustees, however, those powers are meaningless.

It is therefore important that the powers of the trustees are clear and enable the trustees to indulge in almost any activity that a natural person can undertake. Estate duty considerations would also have to be taken into account when drafting the trust deed. It must be determined whether an income beneficiary's right is such that they may be deemed assets in his estate as well as the position of the trustee who also qualifies as an income beneficiary by virtue of discretionary powers of a trustee.

In the first instance if a beneficiary has a vested right to the trust income, such right is similar to a usufruct and it will therefore constitute property in his estate. If the beneficiary only has a contingent right, which is dependent on the trustees exercising their discretion, such right would not be a vested right hence, there would be no inclusion in the beneficiary's estate.

[Olivier, Supra, Page 259:262]

3.11 TAXATION OF TRUST

As mentioned at the outset, taxation is the most common reason for the use of a trust for the reduction thereof. Taxation would include all forms of taxation i.e. income tax; donation's tax; estate duty and transfer duty. When creating a trust it is important that the taxation implications are taken into account. In the drafting of the trust instrument the founder, trustees and beneficiaries should have a sound knowledge of the tax implications for the intelligent drafting of the trust instrument and the subsequent administration of the trust. S 7 and S 103 of the Income Tax Act serve as measures to curb tax avoidance by deeming income to be that of the donor. The following three factors have a bearing on the way in which trust income is taxed:

1. The principles relating to the accrual of income;
2. The conduit principles, which applies specifically to trust income;
3. Certain provisions of the act which deal with deemed income.

In terms of these provisions, income is deemed to have accrued to a person despite the fact that in real terms it has accrued to another. Income from a trust can therefore be taxed in the following ways:

1. The beneficiaries
2. The trust
3. Donor who made the donation, which has resulted in the income being created.

3.12 GROSS INCOME

S 1 of the Income Tax Act, 58 of 1962, defines gross income as follows:

“The total amount, whether cash or otherwise, received by or accrued to a taxpayer during a year of assessment from a source in the Republic or a source deemed to be in the Republic but excluding, receipts or accruals of a capital nature.”

The definition of a “person” in S 1 includes a trust. A trust is defined as follows:

“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.”

3.13 SPECIAL TRUSTS

A Special Trust is defined as follows:

“A trust created solely for the benefit of a person who suffers from any mental illness as defined in S 1 of the Mental Health Act or any serious physical disability, where such illness or disability incapacitates such person from earning sufficient income for his or her maintenance.”

Income of a special trust which vests in a beneficiary, is taxable in the beneficiary's hands subject to the personal rebates provided for in S 6(1) and (2). To the extent to which income does not vest in a beneficiary, it is taxable in the Special Trust.

With regards to the gross income definition, the concept "received by or accrued to" needs to be explained. It was held in *Geldenhuis v CIR* [1947(3) SA 256 C] that "received by" meant, received by the taxpayer on his behalf or for his own benefit. Where the trust object is for the maintenance and education of the founder's children and the trust income is payable to the parent or guardian for this object, the income will be taxed in the hands of the parent or guardian. The rationale behind this conclusion is that the recipient of the income is not subject to a duty to account to the children for expenses incurred or any surplus that may result.

In *Lategan v CIR* [1926 CPD 69] it was held that the meaning of the word "accrued to" meant, "to which any person has become entitled". Therefore if an amount that accrues to the taxpayer in the year of assessment, in which he acquires the right to claim payment in the future, is taxable in his hands, although the amount that has accrued has not yet been received. The value or amount that accrues is the present value calculated as at the last day of the year of assessment. It is an absolute prerequisite of the accrual that the taxpayers right to claim payment is unconditional.

In *CIR v Delfos* [1933 AD 242] it was held that, "accrued to" meant "due and payable".

Once an accrual occurs the taxpayer has a vested right to the income and a cession, which will relieve the cedent of his liability to income tax and allow the income to be taxed in the cessionary's hands is not possible.

Whatever the meaning given to "accrued to" there is no doubt that the taxpayer must be unconditionally entitled to the income before it can be said that the income has accrued to him. A right to income, which is conditional, is subject to an obligation that must still be met and is not an accrual until the condition or obligation has been fulfilled. Once the income has accrued, its taxability is fixed and its ultimate disposal by the taxpayer does not affect its nature as income in his hands.

3.14 SECTION 25(B)

This section affects income received by or accrued to or in favour of a person in his, capacity of trustee. The "deemed income rule" it establishes is that:

- * To the extent to which such income has been derived for the immediate or future benefit of an ascertained beneficiary which has a vested right to it, it will be deemed to be income that has accrued to the beneficiary.
- * To the extent to which it is not derived for the immediate or future benefit of an ascertained beneficiary with a vested right to it, it will be deemed to be income that has accrued to the trust itself.

Section 25B only comes into operation only to the extent where S 7 does not already apply. In the case of a discretionary trust where the trustee is given the discretion in terms of the deed of trust, agreement or will to distribute income, the beneficiary acquires a vested right to the income. For the purposes of the deemed income rule governing the taxation of income of the trust, the income is deemed to be derived for the benefit of the beneficiary.

There is a problem of allowable deductions that must be made to follow the income to which they relate. The deduction would only be allowable to the extent that such income is deemed income. The deemed expenditure rule authorizes an apportionment of the expenditure incurred by the trustee between the income of the trust and income of the beneficiary. If the amount of expenditure and allowances apportioned to a beneficiary exceeds the income deemed to be his, the deduction or allowance is limited to the deemed income in terms of S 25B(4).

The excess reverts to the trust and is deemed income to be a deduction or allowance that may be made in the determination of the taxable income of the trust. Where the aggregate of the deductions and allowances exceed both income of the beneficiary and taxable income of the trust, the excess may be set off against the income of the beneficiary derived from the trust in the next and succeeding years of assessment.

When only the net income of a trust passes to a beneficiary and the beneficiary has no vested right to the capital but is only entitled to receive a share of the income, he is not liable to tax or inadmissible expenditure incurred by the trustees. The trust is liable to tax on the income laid out on such inadmissible expenditure.

[Honore', Supra. Pages 364:371]

[De. Koker, Silke on South African Income Tax. Pages 12-24:12-26]

3.15 SECTION 7(1)

This section deems income to have accrued to a person as long as he has a vested right to such income. It also imposes upon him the duty to declare such right to income in his return of income. The use of the word vested in the trust instrument does not conclusively show that income is that of the beneficiary. Where income is vested in the beneficiary but the trustee has discretion to withhold or accumulate it for a period, the income remains that of the beneficiaries and accordingly taxed in his hands.

The situation is different in a discretionary trust under which the beneficiary has no interest unless the trustee exercises his discretion. Once the discretion has been exercised and the money period over, it must be treated as income of the beneficiary and not the trust.

3.16 CONDUIT PRINCIPLE

The principle was decided in the case of *Armstrong v CIR* [1938 AD 353]. It was held that income subject to a trust retains its identity until it reaches the hands of the person or entity with the vested right. Income therefore retains its identity in the hands of the beneficiaries. Any income that is exempt from tax as provided for in the Act will be available to the ultimate recipient of the income. Therefore, where dividends are received it would be exempt in terms of S 10(1)(k)(l) in the hands of the recipient. Where foreign dividends are received, the beneficiary must be regarded as having received that part of the gross income in terms of paragraph (k) of that definition.

Income flowing through a trust to beneficiaries retains its identity whether it is paid by way of an annuity or in the same other way provided that it accrues to the beneficiaries in the same year of assessment as it accrued to the trust.

This principle evolved of the case *SIR v Rosen* [1071(1) SA 172(A)] and Trollip JA said the following:

“It suffices to say that 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 dividend can no longer be identified or they otherwise lose their character and identity as dividend, and 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 phase. Thus, a trust deed may endow the trustee with a discretion to pass on dividends to the beneficiary or to retain or 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 dividend, 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.”

If income would therefore qualify as exempt income in terms of S 10 of the Income Tax Act, it would be advisable to pay it out in the year of receipt to the beneficiary, as it would still retain its identity as exempt income. If it is paid out in the following year it will lose its identity and would thus merely be income thereby losing its deduction status.

The introduction of S 19(6) provides that income received or accrued in the form of an annuity will be deemed, for the purposes of S 19, to be income derived otherwise than in the form of dividends, notwithstanding the fact that the income may also be in the form of dividend. On the strength of the case of *Armstrong v CIR*, [supra] it has been accepted that the character of a particular profit made by a trust, whether income or capital is retained in the hands of a beneficiary.

[De Koker. Supra. Pages 12-32-1:12-35],

[Olivier, Supra. Pages 169:172]

3.17 SECTION 7(3)

Section 7(3) of the Income Tax Act is as follows:

“(3) Income shall be deemed to have received by the parent of any minor child, if by reason of any donation, settlement or other disposition made by that parent of that child –

- (a) it has been received by or accrued to 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.”

As certain key phrases are not defined in the Income Tax Act one has to look at its literal meaning or at case law. This section can only be applied to income received by a minor child by reason of a donation, settlement or disposition made by the parent. Child does not include a grandchild or stepchild but it will include a legally adopted child. If the donation, settlement or other disposition is made by the parent to the trustee for the benefit of the donor’s child, the provisions of S 7(3) will still apply as there is no requirement that the donation, settlement or other similar disposition must be directly between parent and child.

S 7(3) would normally apply to inter vivos trusts but can only apply to testamentary trusts. In the latter case, if a trust is setup by a grandparent for the benefit of his

grandchildren and donation settlement or disposition made by the parent of the beneficiaries to the trust would be subject to the provision of S 7(3).

In *Platt v CIR* [1934 AD 552] it was held that the intention of the parent to benefit his child is the decisive factor for S 7(3)(b) to apply. It is not important that the child has a vested right to the income or if the child should die before he has received any income.

In a situation where the donor's child is not the only beneficiary, the fact that income accrues to the child by reason of donation, settlement or other disposition of the donor being the parent, that income will be taxed in the hands of the parent. The other beneficiaries whether they are major children of the parent or not related to him at all, will fall outside the ambit of S 7(3).

[Honore', Supra. Pages 376:377]

[Olivier, Supra. Pages 181:183]

3.18 DONATION, SETTLEMENT OR OTHER DISPOSITION

Donation has been defined in the case of *Ovenstone v SIR*, [1080(2) SA 721(A)] that is as follows:

“In the donation the donor disposes of the property gratuitously out of liberality or generosity, the donee being thereby enrichment and the donor correspondingly

improvised, so much so that, if the donee gives any consideration at all therefore, it is not donation.”

In the case of CIR v Berold [1962(3) SA 748(A)] the meaning of donation was amplified in that an interest free loan was regarded as a continuous donation. The words “other disposition” were included in the section specifically to cater for a disposition of property which could not strictly be equated with a “donation or settlement” in accordance with the normal meaning of these expressions.

In the dictionary of Legal Words and Phrases Volume 4 “settlement” is defined as “the benefit of a beneficiary, usually upon specific conditions set out in a deed of settlement”. The words “other disposition” in the case of Ovenstone v SIR [supra] were held to mean the following:

“Any donation settlement or other disposition – excludes any disposal of property that is wholly commercial or business one i.e. made for due consideration, it covers any disposal of property made wholly gratuitously out of liberality or generosity, it also covers any disposal of property made under a settlement or other disposition for some consideration but in which there is an appreciate element of gratuitousness and liberality of generosity.”

An apportionment of tax is possible where income is received partially as a “donation, settlement or other disposition” and partially for some other reason. Where the taxpayer

cannot justify an apportionment as a result of insufficient evidence, the whole of the disposition would be regarded as a “donation, settlement or other disposal” because of the element of liberality or generosity involved.

[Olivier, Supra. Pages 178:180]

3.19 “BY REASON OF”

C.J. Centlivres best explains these words when he delivered the judgement in the case of CIR v Widan [1955(1) SA 226(A)]. He had the following to say:

“When a minor child has received income the inquiry is whether such income has been so received “by reason of any donation, settlement or other disposition” made by the parent to the child. There must be some causal relation between the donation and the income in question. Difficult cases may conceivably arise. Where, for instance, a father donates a sum of money to a minor child and the child buys a business to which he contributed his skill and labour and from which he earns income, that income may be regarded as being attributable to two causes, viz. the donation and the skill and labour of the child.”

In such a case it may be impossible to say which part was the result of his skill and labour and it may be that the Commissioner would not be able to apply S 7(3) – (7).

Therefore, if the Commissioner can prove that the donation, settlement or other disposition is responsible for the accrual of income to the minor child such income will then be taxed in the hands of the donor.

In order to break the causal link and avoid being taxed on the income in the hands of the donor the original donation would have to be reinvested. This reinvestment would ensure that the causal link is broken, even if the income, which ultimately arises, can be remotely connected with the donation, settlement or other disposition sections 7(3) - &(5) apply.

The judgement in CIR v Widan [supra] is clear authority for the proposition that if the purpose and intention of the parent is clearly to benefit his minor child the presumptions will be against the donor in doubtful or borderline cases.

[Olivier, Supra. Pages 180:181]

3.20 SECTION 7(4)

This section is as follows:

“Any income received by or accrued to or in favour of any minor child of any person, by reason of any donation settlement or other person, shall be deemed to be the income of the parent of such minor child, if such parent or his spouse has

made donation, settlement or other disposition or given some other consideration in favour directly or indirectly of the said other person or his family.”

The introduction of this sub-section helps to counter the problem of cross-donations. It is not necessary that the cross donations have to be in equal value for the provisions of sub-section 4 to apply as was held in the case of COT v Paice [25 SATC 385] Clayden J stated the following:

“There must be some causal connection between the disposition by the taxpayer to the other person, and the disposition by the other which leads to income for the children.”

As section 7(4) refers to a donation by the parent or his spouse to the other person, the death of the original donor would not result in this sub-section being inapplicable. The income from the trust would be deemed to be the other spouses.

[Olivier, Supra. Pages 183:1840]

3.21 SECTION 7(5)

This section reads as follows:

“If any person has made a 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.”

For this section to apply the answers to the following questions must be in the affirmative:

- * Did a donation; settlement or other disposition take place?
- * Is the income received by reason of the donation, settlement or other disposition?
- * Is the donation, settlement or other disposition subject to a stipulation or condition to the effect that the beneficiaries or some of them shall not receive the income or portion thereof until the happening of some event, whether fixed or contingent?
- * Is the person who made the donation, settlement or other disposition still alive?

This sub-section refers to the happening of some event and as this is not defined we would have yet again rely on case law.

[De Koker, Supra. Pages 12-35:12-43]

[Olivier, Supra. Pages 184:185]

3.22 EVENT

The attainment of a certain age, date of marriage or some other defined future happening, will constitute an event. It is however unclear that the exercise of a discretion by the trustees for the withholding or distribution of income qualifies as an event in terms of S 7(5).

In the CIR v Berold [1962(3) SA 748] counsel for the taxpayer argued before the Appellate Division of the Supreme Court that the exercise of a discretion by the trustees whether to pay income to the beneficiaries was not an “event” within the meaning of the provision. It was contended that the “event” contemplated in the provision was one that altered the incidence of tax.

Since the exercise of a discretion by a trustee was not an event upon the happening of which the incidence of tax was altered, and since the discretion could be exercised only in relation to income that had already accrued and that had to be deemed to be the income of the donor, the exercise of the discretion was not an “event” within the meaning of the provision. Although the case was not decided on this issue, a similar argument was rejected in ITC 1033.

The Oxford Dictionary explains an “event” as “the fact of a thing’s happening” or a “thing that happens”. The provision of S 7(5) is to tax the income of a trust in the hands

of the donor only when the beneficiaries do not receive it. It has been held in ITC 673 [1948, 16 SATC 230] that S 7(5) first contemplates a hypothesis, namely, the existence of a stipulation that the beneficiary must not receive the income under the deed until the happening of an event. Secondly, it provides what it is deemed to be the devolution until the event takes place. That devolution is given back to the donor if part from the stipulation it would be received by or accrues to the beneficiary concerned.

In *Estate Dempers v SIR* [1977(3) SA 410(A)] it was held by Corbett JA, who delivered the judgement of the Appellate Division that a “a vested right to the accumulated income is not a *sin qua non*.”

A “contingent event” is an event that may or may not happen, and if the beneficiary is not to receive the income until the happening of a contingent event, the beneficiary’s right to that income must similarly be contingent and cannot vest in him.

In practice the South African Revenue Services applies S 7(5) whenever there is a withholding of income in terms of trust deed, no matter whether the beneficiaries have a vested right to the income or merely a contingent right or whether their right to the income is merely a contingent right or whether their right to income is dependent upon the exercise of the trustees discretion.

When the trustees in the exercise of their discretionary powers pay out to the beneficiaries any of the income of trust, it is the practice to subject the donor to tax on the undistributed income. S 7(5) applies whether the stipulation or condition for the withholding of the income from the beneficiary was made or imposed directly by the person making the donation, that is the donor or creator or some other person.

Where a trust has been created by a donor who has made a withholding stipulation a condition in the trust deed, the income derived by the trustees from a further donation made by a new donor to the existing trust will be deemed to income of the new donor.

S 7(5) applies also to persons not ordinarily resident in the Republic who create trusts in the Republic to stipulations regarding the withholding of income. Upon the death of the donor, S 7(5) would no longer apply and the income of the trust would be taxable in the hands of the beneficiaries or the trust in accordance with the terms of the trust deed.

[Olivier, Supra. Pages 185:193]

[De Koker, Supra. Pages 12-35:12-43]

3.23 SECTION 7(6)

This section reads as follows:

“If any deed of donation, settlement or other disposition contains stipulation that the right to receive any income thereby conferred may, under the powers retained

by the person by whom that right is conferred, be revoked or conferred upon another, so much of any income as in consequences of the donation, settlement.”

3.24 SECTION 7(7)

In terms of this sub-section income is deemed to have accrued to the taxpayer if the income has been received by another person after 1 July 1983 in consequence of a donation, settlement or other disposition made before or after the commencement of Act 58 of 1962 provided the following circumstances are present:

- a. There must be a donation, settlement or other disposition made by the taxpayer;
- b. In consequence of the donation, settlement or other disposition the taxpayers right:
 - i. to receive or have paid to him or for his benefit any amount by way of rent, dividend, interest, royalty or similar income in respect of any moveable or immovable property; or
 - ii. with respect to the use of, or the grant of permission to use such property; is ceded or otherwise made over to another person or to third party (such as a trustee) for the benefit of that other person.
- c. The cession must provide that:
 - i. the taxpayer retains the ownership of or an interest in the property; or

- ii. if the property or interest in the property is transferred, delivered or made over to another person or to a third party for the benefit of another, the taxpayer is or will at a fixed or determinable date be entitled to regain his ownership or interest.

- d. In either case the position must be such that but for the donation, settlement or other disposition, the income would have been received by or have accrued to for the benefit of the taxpayer.

In terms of S 7(7)(a) “moveable or immovable property” would include a lease, company share, marketable security, deposit, loan, design, copyright or trademark. The provision of s 7(7) can also apply to a company.

The rationale behind the introduction of section 7(7) was to stop tax avoidance by a taxpayer who ceded his right to income to the person without giving up his control over the income or, in the case of investments forfeits control over the investments.

This sub-section would ensure that the income would be taxed in the hands of the taxpayer that ceded his rights to income.

[Olivier, Supra. Pages 194:198]

[Honore', Supra. Pages 380:383]

According to South African common law principles, a donation is regarded as a contract in terms of which the donor, from pure generosity, gives or promises to give something to the donee as a result of which the estate of the donor is impoverished and the estate of the donee is enriched. In terms of the act a “donation” means, “any gratuitous disposal of property including any gratuitous waiver or renunciation of a right”.

A “donee” means, “any beneficiary under a donation, including a trustee to whom property is donated for the benefit of beneficiaries”. Disposal of property in the context of donation tax refers to inter vivos disposals. Donation tax can only be levied on the disposal of property.

Property is defined in section 55(1) as “....Any right in or to property, moveable or immovable, corporeal or incorporeal, wheresoever situated. Donations tax can be levied if the disposal is gratuitous or if it takes place by way of a sale at an inadequate consideration”. Therefore, property situated outside the Republic would also be included in determining donations tax payable.

[Olivier, Supra. Pages 205:207]

[Honore', Supra. Pages 384:386]

3.26 EXEMPTIONS

Section 56(1) reads as follows:

S 56(1)(d) “Donations tax shall be payable in respect of the value of any property which is disposed of under a donation.”

(d)”...in terms of which the donee will not obtain any benefit hereunder until the death of the donor.”

In the case where a taxpayer donated monies to a trust of which the beneficiaries were only entitled to the income and capital on the death of the donor, it was held that, S 56(1)(d) was not applicable. This was so because the trustees were vested with the bare dominium of the donation of the donated property and that they received a benefit of which the value could be determined under S 62(1)(c).

S 56(1)(l) “... if such property is disposed of under and in pursuance of any trust”. This section basically means that any distribution of trust property to the beneficiaries is to be regarded as a donation for the purposes of donation tax.

3.27 REVOCATION OF A TRUST AND RENUNCIATION BY BENEFICIARIES

Where the founder cancels the trust and he is re-vested with the trust property, the exemption of S 56(1)(l) would apply, as the disposition would be in pursuance of the trust. Should the trust instrument not incorporate a provision that allows for a revocation of the trust, any retransfer does not take place “in pursuance of the trust”, but in terms of an agreement outside the ambit of the trust.

A renunciation by a beneficiary will amount to a renunciation of the beneficiary’s personal right. As it is a gratuitous renunciation of a right, it is likely to fall within the ambit of S 55(1). A disposal can only be taxable if it relates to property, therefore when a personal right is renounced there is a total absence of property and no donations tax.

[Olivier, Supra. Pages 208:210]

3.28 INTEREST FREE LOANS

In CIR v Berold [1962(3) SA 748A] it was held that an interest free loan was a continuing donation, in the context of S 7(3), the interest which could have been charged on the loan. Both interest free loans and low interest loans are potentially subject to donation tax because of the wide definition of “donation”.

[Olivier, Supra, Page 210]

3.29

TRUSTS LIMITS ON HOLDING AN INTEREST IN A C.C.

S 29 of the Close Corporations Act states that a juristic person or trustee of a inter vivos trust may directly or indirectly hold an interest in a C.C. An explanation to this rule is that a natural person trustee of an inter vivos trust who held a C.C interest before 13/-4/87 could continue to do so provided that certain restrictions were met. Where a C.C interest is held in a testamentary trust, no juristic person may be a beneficiary of that trust and in the case where a juristic person is a trustee, such trustee cannot be subject to the control of a trust beneficiary. The idea behind these provisions is that a C.C should not become enmeshed in complicated company holding structures. It is therefore preferable that from an estate planning perspective that high-growth assets be conducted through a company.

[Kourie, Law and Estate Planning, Page 243]

[Davies et al. Trust and Estate Planning]



CHAPTER 4

OFFSHORE TRUSTS – ASSET PROTECTION TRUSTS

4.1 'ONSHORE' TRUST PROBLEMS

The major problem areas relating to the use of Asset Protection Trusts (APT) created within the home jurisdiction, are the high risk of compromising and penetration of both home country (domestic) Asset Protection trusts, Family Limited Partnerships and Limited Liability Companies by the courts, especially in the U.S.A.

The main problem with a domestic APT is that in order for a Settlor to enjoy the full benefit and security of the Trust, he must renounce control or benefit from the Trust absolutely. If you are both Settlor and Beneficiary, you are leaving yourself wide open to claims by your creditors that the Trust is a sham and you are willfully seeking to defraud them.

The courts will rapidly see through such a situation and the Trust will be declared a sham and nullified. *With a domestic APT you cannot safely have your cake and eat it!*

4.2 'OFFSHORE' TRUST ANSWERS

The answer to these problems can be solved by the careful use of an Offshore Asset Protection Trust (OAPT). It is said 'careful' however since it is still of vital importance that two major criteria are met. These are:

- Jurisdiction
- Comity

In this context, jurisdiction means the authority to administer justice in a specific geographical area. A correctly structured OAPT in the correct jurisdiction will be totally beyond the reach of the US courts.

Comity means that the courts in one jurisdiction, even if unconnected politically with another country, will recognize and accede to a ruling made in the courts of another country. It is therefore vital that the OAPT is located in a jurisdiction where this does not apply. The offshore jurisdiction must both be able to (and do) turn round to the US courts and say "this is not our concern, there is no jurisdiction here, we do not recognize and will not implement your ruling".

4.3 ADVANTAGES

There are therefore many advantages to placing assets in a correctly structured Offshore

Assets Protection Trust.

The very fact that your assets are legally held in an offshore jurisdiction outside the control of the courts makes them an unattractive target to creditors. Just imagine the hurdles that face a creditor in commencing a legal action in a jurisdiction perhaps thousands of miles from home against an entity that according to the laws of that jurisdiction has done no wrong.

It may be relatively easy for the creditor to get the Settlor into a court and have a satisfactory judgement pronounced, but being able to action and enforce that judgement in a foreign court and pursue the assets is a very different matter.

The more 'modern' offshore jurisdictions have state-of-the-art Trust legislation which has been designed knowing what may face it yet at the same time be 'Settlor friendly'. There are a number of such jurisdictions scattered about the globe, but it does pay to examine each in turn.

4.4 JURISDICTIONS

Having made the decision to establish an OAPT, one must search for a suitable jurisdiction that meets one's criteria.

By asking the right questions now one can, and will, save major difficulties later on.

These questions include:

* **What is the relationship with my home country?**

A Settlor might decide to use a suitable offshore jurisdiction as physically far away as possible to place yet another barrier, albeit psychological, between himself and his creditors. Others might decide that for convenience, one ‘just down the road’ would suffice.

Always remembering the situation as regards comity between the chosen jurisdiction and ‘home’, there is no real ‘better’ here, but each Settlor must reach convenience against psychological difficulty.

* **How much is privacy and confidentiality respected?**

Many Settlers will face their creditors and relying on the legal strength of their Trust say “This is where my assets are held, and these are the laws protecting them. You cannot touch them”. Others will be as unhelpful and as secretive as possible.

Whichever, you must be certain that the jurisdiction your Trust is executed in will not reveal any details about your Trust arrangements to anyone.

* **What if I move or need to change the jurisdiction of my Trust for any reason?**

Although it may be unlikely that you will ever need to change the jurisdiction of your Trust, you must ensure that should the need ever arise, you can do so. Such eventualities could be beyond your direct control such as a change of government in the Trust jurisdiction, which then shows signs of becoming 'friendly' with your home country and there being comity with your local courts.

There are also a number of smaller but never the less equally important questions to ask:-

- * Is the jurisdiction stable?
- * Is there a language problem?
- * What are communications like?
- * What are the legal and financial support services like (important if you link your Trust with an offshore company)?
- * Can I make use of other offshore services in the jurisdiction?

As good as they may be many instances, domestic APTs Family Limited Partnerships and Limited Liability Companies all have major drawbacks when it comes to the ultimate security of assets in a (especially US) court case.

The establishment of a correctly structured OAPT, whilst at first a daunting thought due perhaps to a different language and certainly due to an unfamiliarity with a foreign legal system, can bring major advantages.

There is such a mystique surrounding OAPT's that it can come as a surprise to many to find that whilst a 'do it yourself' approach is fraught with potential problems, there are a number of organizations, usually offshore based themselves, who are only too willing to help.

CHAPTER 5

THE OFFSHORE TRUSTEE

5.1 INTRODUCTION

When exploring the possibility of establishing a trust, the most common concern that people have is the role of the trustee. This concern is quite valid as control of one's assets are handed over and the Settlor thereby relinquishes control. [*Finkelstein KH, The Tax Haven Guide Book, 1999:129*]. Trustees must be clearly identified in the trust instrument and provision should be made for the replacement of trustees. A trustee could be either a professional or a non-professional person. A professional trustee is normally part of a corporate entity and has limited liability cover against any claims by either the Settlor or beneficiaries. Professional trustees often resign or are transferred therefore choosing a particular entity because of a personal relationship with a specific member may not be a wise move. If a Settlor is obliged to appoint a professional trustee, he should in addition appoint a protector to monitor what the trustees are doing.

5.2 FACTORS TO CONSIDER WHEN SELECTING A TRUSTEE

- * Regulation of jurisdiction in which the trustee operates.
- * Is the trustee required to pay taxes on the property held in trust?

- * The duration the trustee has been in business.
- * What is the value of assets under management by the trustee?
- * Does the trustee carry liability insurance on your property for a value at least twice its market value?
- * Is the liability insurance policy with a reputable and well-known insurance company?
- * Is the trustee subject to an annual audit by an accounting firm of international repute?
- * Will the trustee freely disclose his audited financial statements to you?
- * Did you personally meet the trustee?
- * Is the trustee adequately qualified to manage the trust assets?
- * Have you ensured that legislation in chosen jurisdiction has been complied with?

[Finkelstein KH, The Tax Haven Guide Book, 1999:130-131]

5.3 RESPONSIBILITY OF THE TRUSTEE

Trustee should at all times act in the interest of the beneficiaries. The management of trust assets would also have to be explained to the beneficiaries from time to time. This is a basic right and no trust can function by denying beneficiaries of this right. The trustees should apply reasonable accounting principles and the trust books must clearly indicate what are income, capital, capital gains and accumulated income. Any distributions to beneficiaries must be in accordance of the trust instrument. Where

distributions are based on the discretion of trustees this should be properly documented ensuring that all conditions have been complied with.

Any clauses, which restrict beneficiaries to the right to trust information will definitely render the trust, void. Where secrecy laws exist in a particular jurisdiction, the beneficiaries' right to the information supercede these laws. The trust deed should set out a procedure detailing the manner in which information must be provided to the beneficiaries. Where a trustee is replaced the newly appointed trustee should make sure that the assets have been properly administered and are under the control of the existing trustees.

The current dilemmas facing trustees are as follows:

- * Trust assets are becoming more esoteric and thus more difficult to control.
- * Litigation suits are on the increase against trustees.
- * Flexibility of the trust is being stretched and no precedents exist in this regard.
- * A number of trust companies use standard trust deeds, which may not keep pace with modern trends.
- * Court judgements often in favour of plaintiff as trust companies are seen in a position to pay.
- * Trustees have to be specialists rather than generalists.
- * The speed of delivery information has to be balanced with delivering quality information.

[Roper, Offshore Pitfalls, 1999:Pages 22-24]

5.4

DUE DILIGENCE AND LEGAL LIABILITY OF TRUSTEES

Due diligence basically consists of procedures which help confirm representations made by the parties. It is a process whereby information is gathered and documented and thereafter checked and verified to ascertain the facts in existence. Due diligence may be necessary in the following circumstances:

- * acquisitions
- * mergers
- * investing
- * lending
- * purchase or sale of business
- * securities underwriting
- * financing
- * financial fraud and theft

Settlors would be required to provide documentation to ensure that funds are from legitimate sources.

In the case of *Bartlett et al v Barclays Bank Trust Company Limited [1980, 1 All ER 139]* the bank was a professional trust company and acted as trustee for the plaintiff who had a controlling interest in a private company. The trust company was not represented on the board and two assets were sold without their knowledge. The sale of these assets

resulted in a minor profit being made in one and a huge loss resulting in the other. The court held as follows:

- * The trustee's duty was to conduct business with the care of a reasonably prudent businessman conducting his own affairs.
- * Being a professional corporate trustee a higher duty of care was owed.
- * The bank had a duty as a trustee to receive adequate information on the company's activities.

The courts are therefore not lenient on trustees who take their duty lightly. Utmost care has to be exercised by trustees to ensure that beneficiaries are not prejudiced or suffer any losses. Trustees should be wary of the following:

- * He should not place himself in a position where his duty and personal interest may conflict.
- * He must act gratuitously and may not profit from his trust.
- * If a trustee sells or purchases trust property for his own benefit, this transaction is void.
- * If the trustee purchases the beneficial interest of a beneficiary, the sale is void, unless the trustee has taken no advantage from his position as trustee.
- * He should not be in a position where a duty to beneficiaries conflicts with another set of beneficiaries.
- * Where trustees control a company, they should obtain sufficient information about the company's board and decisions that have been taken.

- * He should exercise the same standard of care that a prudent businessman would in his own affairs.

[Roper, P, Offshore Options, 1999:Pages 29-33]

5.5 CONCLUSION

The duties of the trustee appear to be similar for both on and offshore. In both cases the trustee can sue and be sued, therefore great care has to be exercised in the performance of his duties. A professional trustee will no doubt offer peace of mind but there is unlikely to be a personal relationship with either the Settlor or beneficiaries. It is advisable that a board of trustees is appointed so that at no stage the trust is left temporarily unadministered.

CHAPTER 6

TAXATION OF OFFSHORE TRUSTS

6.1 INTRODUCTION

Governments throughout the world use either one or a combination of the following criteria to impose taxes on individuals or entities. These criteria, aptly named the octopus, are as follows: residence, domicile, citizenship, and marital status, source of income, and location of assets, timing and status of beneficiaries. Taxation is the primary reason for moving assets to jurisdictions with no or low tax implications. However, before an individual moves his assets to these jurisdictions he should obtain the required knowledge of the jurisdictions tax laws to avoid any possible double taxation that may result. The criterion, which is used as a basis of taxation, is briefly discussed below.

6.2 RESIDENCE

6.2.1 INDIVIDUALS

In UK, the term residence is meant to be that the individual must be physically present during the tax year in question or over a series of tax years. The UK system recognizes that a person may be considered to be resident in more than one jurisdiction but will

qualify for any double taxation treaty that may be in place. As resident or ordinarily resident is not defined, the authorities have to rely on case law. One of the leading cases in South Africa that is used to determine whether a person is resident or ordinarily resident is the case of *Cohen v CIR* (1946, AD 174, 13 SATC, 362).

Judge Schreiner when delivering his judgement in the above case said the following:

“..... ordinary residence would be the country to which he would naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principle residence and it would be described more aptly than other countries as his real home.”

6.2.2 COMPANIES

A company that is incorporated in the UK is regarded as a resident. A company incorporated outside is only regarded as resident if the “central management and control” actually resides in the UK.

6.3 DOMICILE

6.3.1 INDIVIDUALS

A person’s domicile is the country in which he has his permanent home. A person may

be resident in more than one country but at any given time, he can be domiciled in only one. A person acquires a domicile of origin at birth. This is normally the domicile of his father and therefore not necessarily the country where he himself was born. He retains this domicile until he acquires a different domicile, either of dependency or choice. If a person settles in another country with the intention of making this his permanent home, the new country becomes his domicile.

6.3.2 COMPANIES

A company is treated as domiciled in its place of incorporation. Trusts are treated in the same way, except that trusts are equipped with “transfer” provisions that purport to be able to extrapolate an existing trusts place of domicile and residence to another territory.

[Trust Domesticity and Residence. Online]

6.4 RELEVANCE OF RESIDENCE AND DOMICILE WITH REGARD TO OFFSHORE TRUSTS

6.4.1 THE SETTLOR

For income tax purposes, the residence and domicile of the Settlor will be relevant to determine the extent to which the anti-avoidance provisions where applicable will cause the income of the offshore trust to be assessed on the Settlor.

6.4.2 THE BENEFICIARIES

The residence and domicile of beneficiaries is relevant to determine the extent to which they are liable to income tax and capital gains tax. Residence and domicile will also be relevant for inheritance tax purposes.

[Fraser, et al, Tolleys Taxation of Offshore Trusts and Funds, 1992: Pages 3-15]

6.5 TAX IMPLICATIONS OF TRUSTS SITUATED IN TAX HAVEN

6.5.1 BAHAMAS

There is no income tax, corporate tax or inheritance in the Bahamas.

6.5.2 THE CAYMAN ISLAND

There is no income tax, capital gains or inheritance or succession in the Cayman Island. An exempt trust therefore grants exemption from any future potential Cayman taxes. There are no exchange controls and the island has its own currency.

6.5.3 GUERNSEY

Income tax at the rate of 20% is payable and other than this no other taxes are payable. Non-Guernsey income and Guernsey bank interest accruing to trusts that have no Guernsey beneficiary is not subject to Guernsey income tax.

6.5.4 ISLE OF MAN

Income tax at the rate of 20% is payable and VAT is collected jointly with the UK, the Isle of Man being a separate administrative area. If there are no Isle of Man beneficiaries the trustees can apply for a tax exemption certificate. The authorities will then seek not to tax the trust on interest payments received from approved Isle of Man financial institutions.

6.5.5 JERSEY

The only tax that levied is income tax at the rate of 20%. Where there are no Jersey resident beneficiaries, the trustees will only be liable to pay Jersey income tax on trust income, which arises in the Island, with Jersey bank interest being exempted. If there are one or more beneficiaries resident in Jersey trustees will be liable to pay Jersey income tax on the income to which the resident beneficiaries are entitled.

[Trident Practical Guide to Offshore Trusts]

The legislation that governs the taxation of offshore trusts is quite complicated and would therefore require the assistance of a professional advisor. Incorrect interpretation of tax legislation could result in hard earned income being lost to the tax collector. The establishment of an offshore trust is an expensive venture. It is therefore advisable that cost versus benefit be determined as the termination of the trust would also incur expenses.

CHAPTER 7

THE HAGUE CONVENTION ON TRUSTS AND THE STATUTE OF ELIZABETH

7.1 INTRODUCTION

The late eighties saw a build up of concern in the offshore world about the lack of clarity of the principles that govern the offshore trust. The only solution was to legislate and this led to a series of legislation, one of which was the “Hague Convention of Trusts”. What are Hague Conventions? Hague Conventions comprise a series of multilateral private international law conventions entered into at inter-governmental level regulating technical matters such as civil procedure, recognition of companies, protection of minors, adoption, recognition of divorce, road traffic accidents etc. These conventions are conducted within the framework of the Permanent Secretariat of the Hague Conference in the Netherlands. *[Glasson, Capacity to create an International Trust: online]*

The text of the Hague Convention of Trusts was finalized in 1984 and thereafter signed and ratified by 3 countries i.e., UK, Italy and Australia. Subsequent to this it has been signed but not ratified by Canada, USA, Luxembourg, France and the Netherlands. The effective date for the commencement of this convention is January 1992.

[Trident Practical Guide to Offshore Trusts, Page 261]

7.2 DEFINITION OF TRUST

The convention has defined the term “trust” as the following:

“Refers to the legal relationship created – inter vivos or on death – by a person, the settlor, when assets have been placed under the control of the trustee for the benefit of a beneficiary or for a specified purpose.”

It also lists the characteristics of a trust, which should include the following:

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

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

The first paragraph refers to “legal relationships”, carefully avoiding any suggestion of division of ownership, focusing rather on the factual element that “assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified

“The Convention does not apply to preliminary issues relating to the validity of wills or of other acts by virtue of which assets are transferred to the trustee.”

This provision makes it clear that although assets may be transferred to a trustee by virtue of a contract, the contract itself is not a trust and its validity is to be determined under the rules applicable to the validity of a contract. Article 4, therefore, only applies to the trust itself and not to preliminary issues (e.g. form, capacity, the validity of the will, deed of transfer etc.).

7.4 ARTICLE 5

This section reads as follows:

“The Convention does not apply to the extent that the law specified by Chapter ii does not provide for trusts or the category of trusts involved.”

This provision makes it clear that although a person may theoretically try to draw up a trust governed by the laws of a particular jurisdiction, the legal situation resulting from such an effort will not be a trust within the scope of the Hague Convention. Chapter ii of the convention presents a list of the requirements of a trust.

This section reads as follows:

“Where no applicable law has been chosen, a trust shall be governed by the law with which it is most clearly connected.

When ascertaining the law, with which a trust is the most closely connected, reference shall be made in particular to-

- a. the place of administration of the trust designated by the settlor;
- b. the status of the assets of the trust;
- c. the place of residence or business of the trustee;
- d. the objects of the trust and the places where they are to be fulfilled.”

Therefore, should a law not be chosen to govern a trust the above guidelines would be used. This list however is intended to be neither hierarchical nor exhaustive. The nature of the trust; its assets and purpose will frequently easily show which of these elements should be given the most weight. Where the governing law is not expressed in the trust instrument, it may be found to be implied in terms of the instrument creating or the writing evidencing the trust interpreted in the light of the circumstances of the case.

[Dyre JD. 99 – International Recognition of the Trust Concept. Available: online]

This section reads as follows:

“The laws specified by Article 6 or 7 shall govern the validity of the trust, its construction, its effects and the administration of the trust.

In particular the law shall govern-

- a. the appointment, resignation and removal of trustees, the capacity to act as a trustee, and the devolution of the office of trustee;
- b. the rights and duties of trustees among themselves;
- c. the right of trustees to delegate in whole or in part the discharge of their duties or the exercise of their powers;
- d. the power of trustees to administer or to dispose of the trust assets, to create security interests in the trust assets, or to acquire new assets;
- e. the power of investment of trustees;
- f. restrictions upon the duration of the trust, and upon the power to accumulate the income of the trust;
- g. the relationship between the trustees and the beneficiaries including the personal liability of the trustees to the beneficiaries;
- h. the variation or termination of the trust;
- i. the distribution of the trust assets;
- j. the duty of trustees to account for their administration.”

When drafting the trust instrument it is imperative that the above provisions are incorporated. This would help avoid exorbitant legal costs and any avenue for the trustees to be shielded against misadministration of the trust. A skilled draftsman should be contracted to ensure that the above provisions are adequately addressed.

7.7 ARTICLES 11-14

These articles deal with “recognition”. It requires recognition of a trust created in accordance with its governing law and states that this will imply that the trust property constitutes a separate fund, and that the trustee may sue and be sued in his or her capacity as trustee. Article 11 reads as follows:

- “a. that personal creditors of the trustee shall have no recourse against the trust assets;
- b. that the trust assets shall not form part of the trustee’s estate upon his insolvency or bankruptcy;
- c. that the trust assets shall not form part of the matrimonial property of the trustee or his spouse nor part of the trustee’s estate upon his death; and
- d. that the trust assets may be recovered where the trustee, in breach of trust, has mingled them with his own property, or has alienated trust assets.”

Many of these provisions have been incorporated in the South African Trust Property Control Act therefore affording the beneficiary protection against personal creditors of the trustees.

7.8 CONCLUSION

The influence of the Hague Convention on Trusts is not limited to its concrete application in the countries, which are parties to it. Countries that have no private international law rules for trusts can use this convention as guidance.

[Dyre JD. 99 – International Recognition of the Trust Concept. Available: online]

7.9 STATUTE OF ELIZABETH

This statute was enacted in 1571 in England and its purpose was to render void any transaction whereby property was transferred to the prejudice of creditors. This statute provided the basis for further anti-avoidance measures for England and much of the world against such practices. The statute allows for transfers of property into trusts to be set aside, even if it was made years before. The statute could therefore be applied even at the time of transfer there was no indication that the particular debt would arise in the future. It is therefore important to select a jurisdiction, which has legislation that overrides this statute or other similar legislation.

[Roper, Ware, 2000, Offshore Pitfalls, Page 108]

CHAPTER 8

THE OTHER SIDE OF THE COIN...

A RECENT U.S. PERSPECTIVE

8.1 INTRODUCTION

The highly-hyped “off-shore asset protection trust” is the latest strategy of those attempting to “stiff” their creditors (real or imagined) or the IRS. Asset protection means arranging one’s business and financial affairs to minimise exposure to creditors. Corporations, limited partnerships and limited liability companies are state-sanctioned asset protection vehicles, since they limit an investor’s potential liability to the amount invested, thus shielding the investor’s other assets (investments, bank accounts and residences) from the claims of creditors.

Although asset protection is a standard part of business and estate planning and is encouraged by state law, the off-shore asset protection trust is a different animal. In contrast to statutory asset protection, which limits one’s liability, off-shore asset protection involves transferring assets (or legal title to assets) to a foreign jurisdiction, thereby, in theory, placing those assets beyond the reach of U.S. court judgements. Generally, these foreign jurisdiction have enacted special legislation that protects debtors against foreign creditors. These laws often run contrary to long-settled U.S. and English

legal concepts. Whereas foreign jurisdictions, such as Switzerland, have long-served as a haven for those persecuted in their home countries for religious or political beliefs, the modern asset protection countries are providing protection for those escaping their home country's legal and tax systems.

8.2 ASSET PROTECTION IS A RISKY BUSINESS

Asset protection is a growth industry. In fact, the prestigious RIA Group publishes a *Journal of Asset Protection*, which contains such uncritical articles as “An Impassioned Argument for Offshore Advocacy as an Ethical Duty”. Ironically, the same journal published a four-part article entitled “Minimising Attorney Liability in Asset Protection Representation” (which should be required reading for the asset protection advocates. Note: An important part of the liability attorneys must minimize is criminal). However, when the Journal actually reports on cases involving asset protection, the debtors are consistently on the losing side.

Those claiming legitimate asset-protection benefits for these vehicles admit there are no U.S. tax advantages. To the contrary, the tax reporting requirements are complex and the potential penalties for non-compliance are huge. Furthermore, the IRS has little trouble compelling taxpayers to disclose their assets.

In the typical case, a U.S. citizen (usually a doctor, attorney, accountant, stock broker, business owner or someone with a large liability exposure) will transfer assets to a trust established in a foreign country to avoid paying on a U.S. court judgement. To attract these investors, the foreign country will have enacted “asset protection” legislation, severely restricting the rights of creditors to recover against the investor – in violation of settled trust law principles. In essence, the investor supposedly has placed his assets beyond the reach of the U.S. legal system to recover any judgements rendered against him. By using the laws of the asset protection jurisdiction, the theory goes, the investor has become judgement-proof (i.e. his assets have been placed beyond the reach of his creditors).

8.3 DOES OFFSHORE ASSET PROTECTION ACTUALLY WORK?

But do these trusts actually work to prevent creditors from reaching your assets? Based on the court cases thus far, the short answer is – NO. Creating an off-shore asset protection trust does not offer much legal protection against determined creditors. Hiding one’s assets overseas may have the practical effect of discouraging creditors from proceeding with a lawsuit in the first place (or settling for less) because of the added expense and risk that they will not be able to collect on a judgement. This deterrence factor is probably the main advantage of using an off-shore asset protection trust, although a well-designed domestic asset protection strategy will, in reality, provide the same benefits and should cost thousands less to create and maintain. In fact, a properly

structured limited liability company formed under state law will provide as much, if not more, protection as the most complex and expensive off-shore arrangement.

The major drawback to off-shore asset protection planning is the mind-set of the typical client who wants to transfer assets outside the U.S. Usually, they are motivated by illegal or improper purposes, such as placing their assets beyond the reach of creditors after a lawsuit has been filed or threatened, or a desire to cheat on their taxes (a criminal felony).

Another problem with asset protection is the enormous power of U.S. bankruptcy laws. For instance, if a debtor transfers assets abroad so that his creditors cannot reach those assets to satisfy their claims, he has probably made himself insolvent. By making himself insolvent, his creditors can force him into bankruptcy and a trustee will take charge of the debtor's estate. The trustee can, under some circumstances, waive attorney-client privilege and obtain the confidential information provided by the attorney to the debtor. A trustee would have little trouble obtaining tax return and tax reporting information exposing the debtor's foreign assets. Armed with this information, the trustee is in a position to undo the asset protection scheme and reclaim the assets for the creditors.

8.4 THE BASIC PREMISE OF OFFSHORE ASSET PROTECTION

The basic premise of off-shore asset protection -- that the laws of the foreign jurisdiction (which contradict well-settled trust law principles) will be enforced to "protect" the

debtor against his creditors -- is flawed. To date, U.S. courts have not upheld laws of a foreign jurisdiction which oppose the public policy of the applicable state law. Applicable state law is usually where the debtor is domiciled (lives permanently).

Because these foreign laws are purposely designed to protect debtors by overruling settled trust laws, these laws cannot withstand an attack on public policy grounds. In other words, it is highly unlikely that a state court judge will overrule the law in his or her jurisdiction and apply the laws of a foreign country, when those foreign laws were intentionally drafted to contradict state law that would otherwise apply.

Another claim made in favour of asset protection is that the foreign country will not enforce a U.S. judgement against a U.S. settlor (debtor) who created the asset protection trust. While this premise is not as solid as it sounds, the focus is misplaced. The critical issue is whether a U.S. court having jurisdiction over the debtor (because he or she is domiciled in the state) will nullify the transfer of assets to an off-shore trust under state law principles or otherwise rule that the transfer of assets to the foreign trust was invalid or illegal in the first place.

8.5 FRAUDULENT TRANSFERS

The first major hurdle that an asset protection plan must clear is the concept that an actual

or potential debtor cannot remove assets from his ownership to prevent a potential or actual creditor from collecting on a judgement. Unfortunately, most people interested in asset protection have a pending claim against them. A transfer of property to an off-shore asset protection trust may constitute a fraudulent transfer under the Uniform Fraudulent Transfer Act. (*California's version of the Act is found in California Civil Code Sections 3439 et. seq.*). If the settlor has already committed an act that could give rise to a legal claim against him, it is usually too late to transfer assets to a foreign trust.

There are two basic types of fraudulent transfers that creditors may challenge: actual intent and constructive intent transfers.

8.5.1 ACTUAL INTENT TRANSFERS

A transfer is deemed fraudulent and may be set aside if it is made with the “actual intent to hinder, delay or defraud any creditor” of the transferor, whether present or future.

{California Civil Code Sec. 3439.04(a)}

8.5.2 CONSTRUCTION INTENT TRANSFERS

Generally, a construction fraudulent transfer occurs when property is transferred for “less than reasonable value”, if any of the following three requirements are met:

1. The debtor is left with “unreasonably small” assets for carrying out the business in which the debtor is engaged or about to engage.

{California Civil Code Sec. 3439(b)(1)}

2. The debtor intended to incur, or reasonably believed or reasonably should have believed, that he or she would incur debts beyond his or her ability to pay as they became due.

{California Civil Code Sec. 3439.04(b)(2)}

3. The debtor was insolvent or became insolvent as a result of the transfer.

{California Civil Code Sec. 3439.05}

Generally, there is a four-year statute of limitations for “constructive” fraudulent transfers. For “actual intent” fraudulent transfers, legal action can be brought at any time before the later of (1) four years after the transfer was made; or (2) within seven years of when the transfer was made, as long as the action is brought within one year after the transfer or obligations could reasonably have been discovered by the claimant.

{California Civil Code Sec. 3439.09}

The fraudulent conveyance laws prevent those with actual creditors from using asset protection. The ideal client is one with no actual creditors and who is lucky enough not to have a creditor appear on the scene within four years after the transfer has been made.

Unfortunately, this is but one of several roadblocks confronting the asset protection scheme.

8.6 POTENTIAL CRIMINAL LIABILITY INVOLVING ASSET PROTECTION SCHEMES

In addition, every person (which may include the perpetrator's advisors) who is part of a fraudulent conveyance with the intent to defraud or deceive others, may be guilty of a crime (*California Penal Code Section 531*).

Under federal law, 18 USC 371, an attorney may be convicted of engaging in a criminal conspiracy to defraud the United States. A conspiracy exists when two or more people agree to commit a crime against the United States and there, in furtherance of their agreement, one of the conspirators commits an overt act. Clearly, the participation of an advisor in the formation of an asset protection trust to evade U.S. taxes would fall within the criminal conspiracy statutes.

Engaging in fraudulent asset protection schemes may also violate the Racketeer Influenced and Corrupt Organizations law ("RICO"). *18 USC 1961 et seq.* If two acts of racketeering occur within a 10-year period, and the perpetrator was associated with the enterprise and participated in the conduct of its affairs through the operation or management of its operations, he could be convicted under the RICO laws. An enterprise

can mean an informal activity, such as an asset protection trust. Also, a crime such as mail fraud can be an offence that triggers the application of the RICO laws.

Also, the Money Laundering Control Act, 18 U.S.C. 1956, (“Act”) is broad enough to encompass asset protection schemes. Many people mistakenly believe the federal money laundering statutes apply only to drug trafficking or organized crime. Actually, the list of potential offences is quite long and includes tax evasion (IRC Sec. 7201), tax fraud and false statements relating to taxes (IRC. Sect. 7206).

Committing a crime of tax evasion, then concealing the proceeds with foreign bank accounts, violates the Act. The Act states that if the government can show: (1) that the defendant knew that the property involved in a transaction represented the proceeds from a criminal activity; and (2) that the defendant intended to engage in tax evasion or filing a false tax return, or knew the transaction was designed to conceal the proceeds of a crime or to avoid the reporting requirement under federal or state law, then the defendant can be subject to a \$500 000 fine and sentenced up to 10 years in prison.

In the context of asset protection, if the crime of tax evasion or filing a false tax return has been committed, then the act of concealing the proceeds through foreign banks, the failure to disclose the transaction as required under the new trust reporting requirements, or the failure to disclose related party transactions with IRS Form 5742, could constitute a violation of the money laundering statute.

The taxpayer's advisors are subject to IRC Sec. 7206 which states that any person who willfully aids or assists in the preparation of a false return is also liable. Consequently, an advisor who counsels a client to violate U.S. tax law (including advising a client that certain reporting requirements can be ignored), and then assists the client in an off-shore asset protection scheme, can be prosecuted under the Act.

CHAPTER 9

CONCLUSION

The trust can offer substantial advantages if properly structured and administered. For far long there existed the myth that the trust should only be utilized by the super rich. The average individual can ensure that his dependants are properly taken care of by merely incorporating a testamentary trust in his will so that insurance proceeds and estate income are properly administered by trustees.

A professional company of trustees could be appointed as this will ensure that there is always a trustee to the assistance of his dependants. Recovery of losses against the trustee is assured and the highest standard of professionalism is guaranteed. The selection of the right trustee therefore offers peace of mind as the Settlor relinquishes all forms of controls over the donated assets.

The Settlor is the person who initiates the creation of a trust therefore his intention to create a trust should be specific to avoid any legal battles. He should comply with all the requirements for the creation of a trust. The donated property and purpose of the trust must be clearly defined. With regards to donation of property the tax implications must be taken into account so that the Settlor is not burdened by a huge tax bill.

The trust deed, trust instrument or letter of wishes as is often known is the heart of the trust. When drafting the trust deed it is advised that an experienced draftsman is appointed so that all the necessary clauses are incorporated for the trouble free operation of the trust. The tax implications must be carefully considered as well as any anti-avoidance legislation.

The offshore trust can offer numerous advantages. This is usually a cost venture so the use of an offshore specialist is advised. Factors affecting trust locality must be carefully studied as the selection of an inappropriate locality could cause hard earned wealth to be lost. Legislation of the choice of jurisdiction must be studied so that nothing is a surprise to the Settlor.

Both on and offshore trusts are useful vehicles in asset protection, estate duty and normal tax savings.

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