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Is a foreign trust right for your client's estate plan?



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A foreign trust can be an essential part of an estate-planning toolkit. While not suitable for everyone, it can assist a high-net-worth family to achieve their estate-planning goals in a very effective way.¹

What are the benefits?

A foreign trust creates the opportunity for continuity and disciplined governance. Assets can be managed in a single vehicle with a single mandate across various generations. The settlor's death should not disrupt the management of the trust.

If managed correctly, a foreign trust may also provide a family with protection against 'life risks'. As the trustees of a discretionary trust can determine how and when beneficiaries benefit, the trust may assist in protecting assets against divorce actions, insolvency, addiction, creditor threats and spendthrift behaviour.

If the family's long-term asset base is predominantly offshore, or will become so over time, a foreign structure may be preferable to a local structure. Growing family wealth outside of personal estates can often be achieved effectively through a well-structured foreign trust.

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1. The decision to use an offshore trust will depend on factors such as the applicable tax laws, the client's circumstances and investment structure. This is the copyright of Ninety One and its contents may not be re-used without Ninety One's prior permission.

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If beneficiaries live in different countries, a foreign trust can potentially help facilitate smoother cross-border administration and succession. However, the legislation of the jurisdictions in which the beneficiaries are tax resident should also be considered, as it may result in a foreign trust not being the correct estate-planning vehicle for the family.

Where the settlor is currently tax resident in another jurisdiction but plans to take up tax residency in South Africa, the opportunity to settle a trust before becoming tax resident should be examined. If funds can be donated to the trust without tax implications in the current foreign jurisdiction, it may result in a highly tax-efficient vehicle for the settlor once they become tax resident in South Africa.

Why is it not for everyone?

As with any other structure, fees are payable and the benefits to the family, whether financial or not, need to outweigh the costs and other administrative implications. Typical fees comprise the trust establishment fee, onboarding fees, annual trustee fees and trust administration fees which normally include accounting fees, payment fees and compliance fees. These fees are normally a combination of fixed and time-based fees and not necessarily linked to the quantum of the assets under the administration of the trustees. Generally, the larger the value of the trust's assets, the less significant the fees become.

One way of mitigating the onboarding and compliance fees is to utilise the same jurisdiction for both the trust and the investments. For example, where a client intends to invest through the [Ninety One International Investment Portfolio](#), offered by Ninety One Guernsey Limited, establishing the foreign trust in Guernsey may offer operational and cost efficiencies. Consolidating investments and reporting on a single platform should further help to reduce fees.

Where funds are settled into a trust, the settlor no longer controls such assets. If funds are lent to the trust, the lender can recall the loan in line with the terms of the loan agreement. Where the settlor desires to retain control over all the assets and not just the loan amount, a foreign trust will not be a suitable vehicle.

A foreign trust is not a short-term solution, and the benefits often only become compelling over time, sometimes only from the second generation onwards. Excess funds, being funds not required by the beneficiaries in South Africa over the short to medium term, should be utilised to fund the trust. Having to bring back funds to South Africa shortly after they were transferred to the trust can result in currency exposure, the realisation of investments at inopportune times and unnecessary fees.

How do you fund a foreign trust?

A foreign trust funded by a non-resident for South African tax purposes can be a very tax-effective structure for South African tax residents. Typically, however, the funds available to fund foreign trusts are in the hands of South African tax residents, being individuals, companies or trusts. The South African tax and exchange-control consequences of the funding mechanism must therefore be considered carefully.

While tax should not be the main driver for the establishment of a foreign trust, the South African tax implications of funding the trust play a considerable role in determining whether a foreign trust is a suitable vehicle in the circumstances. If the funds are held by an individual, they may donate the funds to the trust, loan the funds to the trust or bequeath the funds to the trust on death.

A donation by a South African tax resident will trigger South African donations tax to the extent that the donation exceeds the applicable annual exemption, currently R150 000 for natural persons. Donations tax is currently levied at 20% up to R30 million (cumulative donations since 1 March 2018) and thereafter at 25%. A donation will also result in attribution of income back to the donor. Due to the tax implications, this is not a method often used.

Loan funding is more common because it prevents an immediate full-value donation. If interest is charged on the loan, the interest is taxable in the hands of the lender at such lender's marginal tax rate. If no interest is charged or the interest rate is lower than the SARS official rate of interest and/or lower than an arm's length interest rate, then the transfer pricing provisions, attribution provisions and section 7C of the Income Tax Act must be considered. The interaction between these provisions is complex and more than one of the provisions can apply simultaneously.

Where the funds are in South Africa, the lender must obtain the necessary SARS and SARB approvals (where applicable) to externalise the funds.

If the assets are currently owned by a South African trust structure, a trust-to-trust distribution can be considered where the trustees of the South African trust exercise their discretion to distribute a capital amount to the trustees of the foreign trust. This requires both SARS and SARB approval and certain requirements must be met including that the local trust deed must allow for the distribution to the foreign trust and that all taxes must be paid.

Bequeathing personal foreign assets to a foreign trust will result in the foreign trust receiving a capital amount. While the assets will still be subject to estate duty in the estate of the deceased South African tax resident, there will not be further estate duty on these funds for the next generation once it is held in a trust.

How are payments or distributions from the foreign trust treated for tax purposes?

Where a loan has been granted to the trust, loan repayments can generally be made by the trustees without any tax implications for the tax resident lender.

Where there is no loan to repay, the trustees may decide to make a distribution to a South African tax resident. The nature of the distribution will determine the tax implications. Current year income and current year capital gains will be taxable in the beneficiary's hands (similar to the case where a local trust distributes to South African tax resident beneficiaries). However, accumulated income and accumulated capital gains (i.e. income and gains from previous years) will also retain their nature and be taxed accordingly (dividends at 20%, interest and other income at 45%, capital gains at an effective maximum rate of 18%). This differs from the local trust scenario as in the case of a local trust, undistributed income and capital gains would have been taxable in the trust itself in the year they arose. The treatment of distributions is subject to the attribution rules, which must therefore be considered first.

Any amounts donated to the trust, inherited by the trust or received by the trust as a capital distribution from another trust, will constitute capital for South African tax purposes if distributed by the trustees. Distributions from such capital will not be subject to income tax in South Africa.

The trustees can choose from what source they make distributions provided there is still an available balance of the elected source for distribution. Sufficient accounting records must be kept by the trustees to substantiate the source of any distribution.

In the event that the trustees elect to make a loan to a South African tax resident beneficiary, there is no requirement from a South African tax point of view that interest must be charged on the loan. The trustees may, however, decide to only extend the loan on condition that they charge interest. If interest is charged by the trustees, it may not exceed a market-related rate and a withholding tax on interest of 15% may apply.

The nature of the distribution will determine the tax implications.

How do you assist your client to decide?

Before recommending a foreign trust, advisors should consider all the factors and obtain expert advice where necessary. Firstly, establish the facts. Where is the client tax resident? Where are the assets located and what is the value of the assets? Where are the intended beneficiaries currently based, and where are they likely to be based in future? What are the main reasons for considering the establishment of a trust?

Secondly, consider how the trust will be funded, what distributions will be required and the tax implications of the funding and distributions. Is the trust to be funded by way of donation, loan, trust distribution or another bespoke funding mechanism? Will distributions be required in the short to medium term?

Finally, ensure the client understands the practical working of a foreign trust, the roles of the relevant parties, how decisions are made and what guidance the trustees may require.

A foreign trust is not right for every estate plan. But where there is an offshore asset base, internationally mobile beneficiaries, or a need for long-term governance and protection, a foreign trust can be a very effective structure.

Advisors should consider all the factors and obtain expert advice where necessary.

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