

The Budget and taxation of trusts

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Since the Budget Speech there has been a lot of speculation in the media regarding the taxation and, for that matter, the future of trusts. Up to this point it remains nothing but speculation. One would hope that the proposed draft legislation will be published in good time in order to afford interested parties ample time to make representations.

Personally we think that the tax saving supposedly achieved through the medium of the trust is exaggerated and we hope that this misconception will not lead to punitive legislation which will be to the detriment of a very useful vehicle of which the main purpose should definitely not be the saving of tax.

We are of the opinion that, should the existing anti-avoidance provisions in the act be applied properly by SARS, it leaves a very little space for the saving of Income tax through the medium of a trust.

Please note that our interpretation and subsequent calculation below are based on an objective analysis of the wording of the proposed amendments as given below. We cannot guarantee the correctness of our interpretation but, based on the wording, it is the only interpretation that we can objectively arrive at.

In the 2013 Budget Review the following is said regarding the taxation of trusts.

To curtail tax avoidance associated with trusts, government is proposing several legislative measures during 2013/14. Certain aspects of local and offshore trusts have long been a problem for global tax enforcement due to their flexibility and flow-through nature. Also of concern is the use of trusts to avoid estate duty, which will be reviewed.

The proposal will not apply to trusts established to attend to the legitimate needs of minor children and people with disabilities.

The proposals are as follows:

- *Discretionary trusts should no longer act as flow-through vehicles. Taxable income and loss (including capital gains and losses) should be fully calculated at trust level **with distributions acting as deductible payments to the extent of current taxable income**. Beneficiaries will be eligible to receive tax-free distributions, **except where they give rise to deductible payments (which will be included as ordinary revenue)** (Our accentuation).*
- *Trading trusts will similarly be taxable at the entity level, **with distributions acting as deductible payments to the extent of current taxable income**. Trusts will be viewed as trading trusts in they either conduct a trade or if beneficial ownership interests in these trusts are freely transferable (Our accentuation).*

- *Distributions from offshore foundations will be treated as ordinary revenue. This amendment targets schemes designed to shield income from global taxation.*

The wording of the above information is, to say the least, confusing. It deals basically with the so-called “flow-through” principle (more commonly known as the conduit principle) applicable to trusts. As the reader will note, there is a cursory reference to the avoidance of Estate Duty through trusts but it says nothing apart from mentioning that it will be reviewed.

The paragraph dealing with discretionary trust basically states that the conduit principle will no longer apply but then goes on to say that the taxable income will be calculated in the trust **“with distributions acting as deductible payments to the extent of current taxable income”**. The paragraph goes further to state that beneficiaries will be eligible to receive tax-free distributions, **except where they give rise to deductible payments** and states that deductible payments will be included as ordinary revenue (in the hands of the beneficiary).

We interpret this clause to mean that any income in the trust that is distributed to beneficiaries in terms of the trust deed will be taxable in the hands of the beneficiaries and any income not so distributed will be taxable in the trust. There is very little difference between this and the existing conduit principle. The exception may be that the income might not retain its identity as is the case with the current conduit principle.

Paragraph 7(5) of the Income Tax Act will most probably also be revoked due to the fact that it hasn't made any sense since the tax rate of trusts has been increased to 40%. The same applies to the similar anti-avoidance provisions in the Eighth Schedule to the Income Tax Act.

At the moment it is not clear what will be achieved by this change in legislation and we can only but wait and see. The paragraph dealing with trading trusts basically states that the same tax dispensation will apply to trading trusts. If this is the case, why do they deem it necessary to distinguish between normal discretionary trusts and so-called trading trusts? Your guess is as good as ours!

The last paragraph deals with distributions from off-shore foundations and speaks for itself.

Firstly, it must be stressed that the proposed legislation is basically aimed at the misuse of trust for avoidance of tax and more specifically income tax. At this point in time the proposed legislation does not seem to be too punitive.

Secondly, the cursory reference to Estate Duty should not be ignored but, on the other hand, we have had this kind of statement on a regular basis over the past twenty years and, until now, nothing has materialised.

It makes no sense to base tax planning on possible legislation which, as with some proposed legislation in the past, might never see the light of day or, if it does, might not be nearly as drastic or detrimental to the taxpayer as it might seem in the beginning. Clearly one should take cognisance of proposed developments but a “wait and see” attitude has never before worked in tax and estate planning.

For the sake of clarity following below is an example of how we interpret the proposed new income tax dispensation of trusts.

CALCULATION

ABC TRUST receives income of R200 000-00. Deductible expenditure amounts to R100 000-00.

The trustees decide to distribute R50 000-00 of the income to beneficiary **D** in the same Tax Year and, at the same time, decide to distribute capital (from income already taxed in the trust in previous years) to the amount of R50 000-00 to beneficiary **E**.

The tax position should be as follows:

TRUST

Income	R200 000-00
Expenditure	<u>R100 000-00</u>
Taxable Income	R100 000-00
Less: Distribution (“deductible payment”)	<u>R 50 000-00</u>
Trust will be taxable on	R 50 000-00

D

D will be taxable on R 50 000-00

E

The distribution will be tax-free being a capital distribution

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Activities of FISA members include but are not restricted to the drafting of wills, administration of trusts and estates, beneficiary funds, tax and financial advice and the management of client funds.

FISA has over 700 individual members, who collectively manage in excess of R260 billion. They draft several thousand wills each year and administer around 50 percent of deceased estates reported to the Master's Office.

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