practical implications of the Davis Tax Committee’s recommendations

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Davis Tax Committee first interim report on estate duty (DTC report)

- released on 13 July 2015

- “many deficiencies of the current estate duty system be addressed by way of... simple yet fundamental amendments to the existing legislation”

- donations tax, capital gains tax, estate duty and the taxation of trusts

- focus on use of trusts for tax planning purposes, in particular, in context of estate planning

- recommendations are not draft tax legislation
The common assumption is that trusts are some kind of tax panacea... Then, conversely, from a...SARS...perspective trusts are viewed with a degree of suspicion and mistrust. [T]he truth lies somewhere between these positions. Trusts are useful vehicles, but there is little tax magic that arises from the utilisation of a trust.”
taxation of trusts – general principles

- ownership trust – founder/settlor transfers ownership of property to trustee(s) to be held for benefit of defined/determinable beneficiaries

- 2 different types of ownership trusts –
  - vesting trust - beneficiary right to distributions which cannot be defeated, right passes to cessionaries/estate upon death
  - discretionary trust - trustees have discretion to make distributions to beneficiaries

- **bewind** trust – founder/settlor transfers ownership of property to beneficiaries; administration and control of property given to trustees
why are trusts used?

- perpetual succession – trust can in theory exist in perpetuity
- popular vehicle through which to conduct business activities - business not interrupted by death/insolvency of donor
- generation skipping vehicle for estate planning purposes
- vehicle to hold complex assets, e.g. farms, shares in family business
- flexibility - can be amended with relative little formalities (amended deed submitted with Master and now also to SARS)
- asset protection – do not form part of donor’s estate
- testamentary trusts
- charitable institutions (PBO’s)
taxation of trusts – general principles (continued)

- conduit principle – income flowing through trust retains its identity, trust merely conduit and not a separate entity (*Armstrong v CIR 1938 (AD)* and *SIR v Rosen 1971 (AD)*)

- trust is a person in terms of Income Tax Act

- new tax returns for trusts - detailed disclosures relating to donors and beneficiaries
taxation of trusts – statutory provisions
taxation of trusts – statutory provisions (continued)

- attribution rules / settlor charges
  - income - section 7(5)
    - any person
    - gratuitous disposal to trust (i.e. local or offshore) subject to condition/stipulation that beneficiaries may not receive income until happening of some event, e.g. exercise of discretion by trustees of discretionary trust
  - attribute retained income derived from gratuitous disposition to that person
  - similar provisions relating to capital gains – paragraphs 70 and 72
taxation of trusts – statutory provisions (continued)

• funding in context of offshore trusts
  - transfer pricing – section 31
    • arm’s length, i.e. market related, interest rate must be charged in respect of cross-border provision of loan funding
    • “affected transaction” - between resident and non-resident who are connected persons in relation to one another
    • “connected person” in relation to trust includes beneficiary
distribution rules

- income

  - section 25B read with section 7(1)
    - vesting trust - income received/accrued taxed in hands of vested beneficiary/ies, i.e. trust is transparent
    - discretionary trust - income received/accrued taxed in hands of trust, unless distributed to beneficiary before fiscal year end of trust, in which case taxed in beneficiary’s hands

- income taxed in hands of trust, on subsequent distribution to beneficiary - distribution treated as capital in hands of beneficiary
taxation of trusts – statutory provisions (continued)

- section 25B(2A)
  - capital may be taxed in beneficiary’s hands as income if
    - SA resident beneficiary acquires vested right to amount representing capital of *offshore trust*
    - capital arose from receipts/accruals that would have constituted income if trust had been resident, determined in any tax year which resident had contingent right to amount; and
    - amount not been subject to tax in SA
taxation of trusts – statutory provisions (continued)

- capital gains
  - paragraph 80(2)
    - capital gain taxed in hands of SA resident beneficiary if gain vested in beneficiary in same tax year that arises
    - if capital gain vested in non-resident beneficiary, trust taxed on gain
DTC report recommendations

- trusts should be taxed as separate taxpayers
- flat rate of tax for trusts maintained at existing level, i.e. 41%
- provisions in terms of which income of local trusts can be taxed in hands of beneficiaries/donor at individual marginal tax rates as opposed to higher flat rate of tax in trust, should be removed
- attribution rules pertaining to offshore trusts should be retained
all distributions by offshore trusts to SA resident beneficiaries should be taxed as income

no attempt should be made to tax interest-free loans advanced to South African trusts

criminal action could be taken against taxpayers who fail to disclose direct/indirect interests in foreign trust arrangements

no amnesty provided
comments on DTC report recommendations

- conduit principle
  - DTC proposes to remove conduit principle for local trusts
    - conduit principle - well established in SA common law and entrenched in legislation
  - *bewind* or vesting trusts - liable for tax on income/capital flowing through it?

- consider interaction with other jurisdiction(s) where beneficiary/ies reside
  - distributions to non-resident beneficiary – potential double taxation?
comments on DTC report recommendations (continued)

• no relief from double taxation in terms of double tax treaty since trust and beneficiary/ies different persons for tax purposes

• *e.g. Israeli tax*
  - distributions from SA trust to Israeli beneficiary - flat rate of 30% (does not distinguish between income/capital)
  - trustees may elect trust income allocated to Israeli beneficiary be taxed at flat rate of 25%
  - on death of funder and spouse – trust becomes Israeli taxpayer subject to Israeli tax in respect of all assets
offshore trust distributions

- distinction between
  - distributions of original corpus
  - income and capital receipts
  - repayments of loans
- taxpayer carries onus of proof to provide adequate records to substantiate nature of distributions
- criminal sanction – many clients not aware of fact that they are beneficiaries of offshore trusts
taxation of estates

- estate duty
  - section 4(q) deduction of property to surviving spouse
  - deduction in respect of offshore assets
  - R3.5m primary abatement

- CGT
  - paragraph 40 - deemed disposal at date of death (exemption of property to surviving spouse)
  - paragraph 67 – exemption of property disposed of by estate to surviving spouse

- donations tax
  - exemption of donation to spouse
  - exemption in respect of offshore assets
DTC report recommendations

- consider repeal of section 4(q)
- consider repeal of portable abatement
- primary abatement increased to R6m; surviving spouse may increase total abatement to R12m
- donations tax exemption between spouses exclude interests in immovable property or companies
- revisit donations tax exemption in respect of offshore assets
comments on DTC report recommendations

- property left to surviving spouse
  - liquidity issues - surviving spouse not in position to pay liability; estate consist mainly of illiquid assets
  - give rise to hardship served to avoid
  - not in line with CGT exemption
  - merely accelerates timing of payment of estate duty

- donations between spouses
  - for reasons other than saving tax e.g. spouse contributed to repayments on mortgage bond

- donation of offshore assets
  - originally acquired as non-resident
  - consistent with similar estate duty exemption
conclusion

- if DTC Report recommendations implemented – all domestic trusts taxed as separate taxpayers
  - income – flat rate of 41%
  - capital gains – effective rate of 27.31%

- “the repeal of the attribution provisions will have diverse and far-reaching implications... An extensive consultative process will have to follow ... to identify and address the many issues involved”
conclusion (continued)

- once scope of legislative changes finalised - period should be allowed for taxpayers to re-evaluate interests and determine whether to continue with current trust arrangement/dissolve same prior to implementation

- not sufficient detail in DTC report to take action BUT advisable to adhere to proper governance and to ensure correct disclosures made to all revenue authorities