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

taxation of trusts - introduction

- *Broomberg on Tax Strategy –*
    - *"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

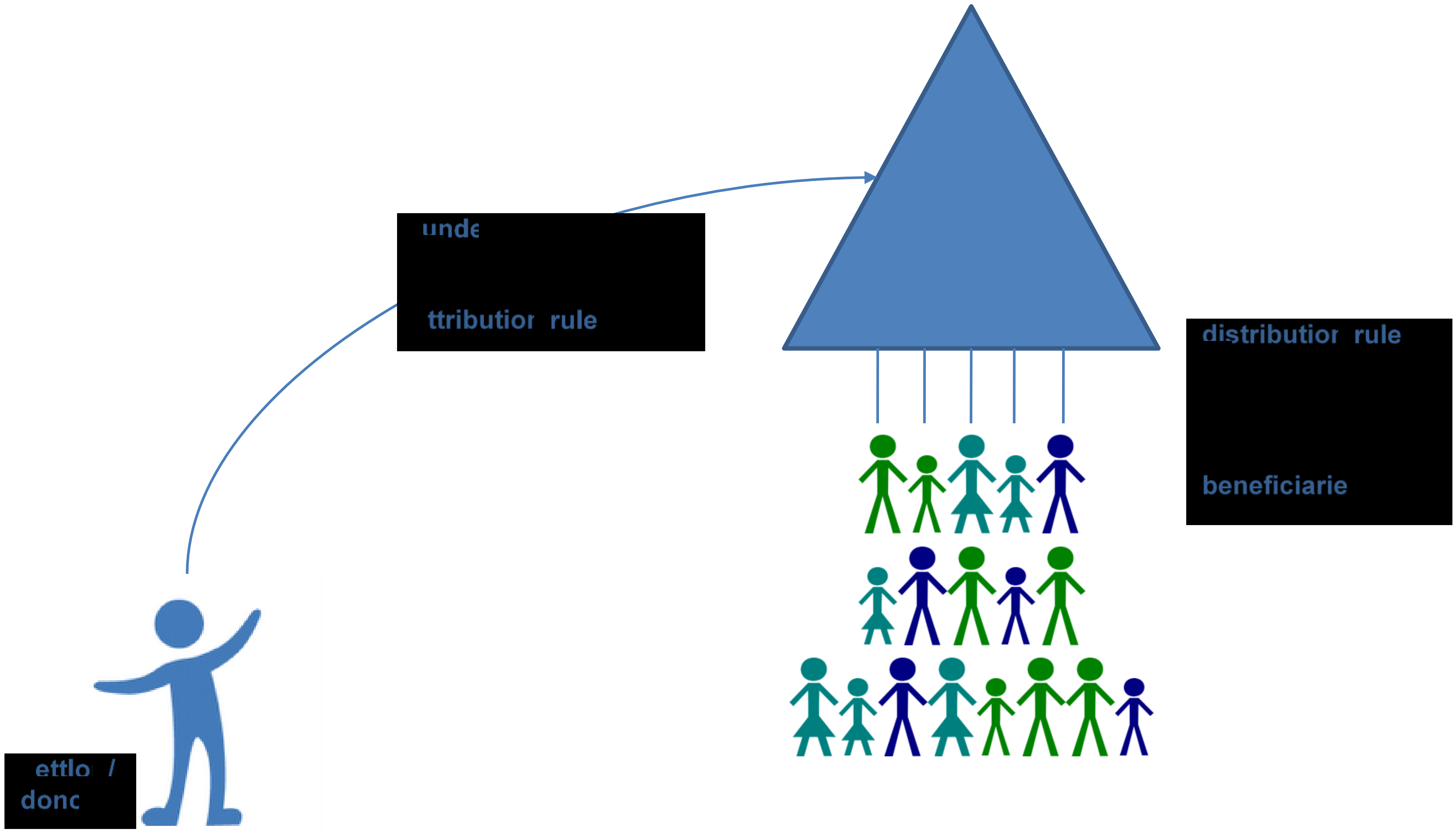
taxation of trusts – general principles (continued)

- 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)
    - <u>any person</u>
    - gratuitous disposal to <u>trust (i.e. local or offshore)</u> 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

taxation of trusts – statutory provisions (continued)

- 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 <u>offshore trust</u>
    - 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 <u>non-resident beneficiary</u>, 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

DTC report recommendations (continued)

- 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

comments on DTC report recommendations (continued)

- 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