Publication: Personal Finance (Saturday Weekend Argus)
Date: 27 Feb 2016
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Interest-free loans to trusts under the spotlight

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National Treasury has issued yet another warning of its intention to stop tax avoidance through the use of trusts.

The Budget Review document that accompanied Finance Minister Pravin Gordhan's Budget this week indicates that people who set up and make use of trusts can expect amendments to the Income Tax and Estate Duty Acts this year that will seek to stop them from shifting assets into a trust in ways designed to avoid estate duty and donations tax.

The document, which suggests that such actions "create inequality", says Treasury is considering introducing legislation that will ensure that if you move your assets into a trust by giving the trust an interest-free loan to buy the assets from you, the transaction will be deemed to be a donation.

This means that, after the donations tax exemption of R100 000, you will pay donations tax at 20 percent of the value of the asset you move into the trust.

Cecil Morden, the chief director of economic tax analysis at National Treasury, says the avoidance of tax is exacerbated when you grant a trust a loan that is interest free, because you do not receive interest – on which you can pay tax – and the value of the loan is eroded by the time value of money.

The loan granted to the trust typically remains an asset in the estate of the donor, but it does not increase in value for the donor because the growth in the asset occurs in the trust and the loan does not attract interest.

Typically, the donor also reduces the loan each year by donating to the trust the maximum amount that you can donate without paying donations tax (R100 000) to the trust. By the time the donor dies, the loan is either greatly reduced or written off.

The growth in the asset takes place in the trust, and the trust can distribute income or capital to the beneficiaries in a way that minimises the tax payable.

Morden says an alternative proposal to making the interest-free loan a once-off donation is to deem the income you should have received on the loan (had you charged the trust interest) to be an ongoing donation, to which donations tax and, potentially, income tax will apply.

Treasury is also considering including the interest-free loan in the estate of the person who grants the loan. Although this appears to suggest that you will be taxed twice on the amount moved into the loan, Morden describes it as "another option".

He says the disposal of an asset to a trust on loan account will not be deemed a disposal for estate duty purposes, so the growth in the value of the asset in the trust will still be taxable in your estate.

A potential for double taxation may arise depending on the permutation that is finally settled on after consultation, he says. If that is the case, either the loan or the donations tax on the loan will be taken into account in determining the estate duty due on the asset, Morden explains.

INCOME SPLITTING

The Budget Review also states that further reviews will be undertaken to limit perceived "income-splitting" in discretionary trusts.

Income-splitting occurs when income from the trust is passed on to a number of beneficiaries, typically with lower tax rates, to reduce the tax payable.

Louis van Vuuren, the chief executive of the Fiduciary Institute of South Africa (Fisa), and Emil Brincker, a director and the national head of Cliffe Dekker Hofmeyr's tax and exchange control practice, say trusts are not only created to move assets out of an estate to avoid tax. Trusts play an important role in protecting business owners' assets from potential insolvency and protecting assets for those who are incapable of dealing with them, because they do not have the skills or are too old or too young.

Treasury's proposals in the Budget Review come ahead of an expected second report on estate duty from the Davis Tax Committee, the eight-member committee under Judge Dennis Davis, which was appointed in 2013 to review South Africa's tax policy.

Van Vuuren says the first report on estate duty published last year included proposals to do away with the conduit principle in trusts, but to leave interest-free loans in place.

The conduit principle means a trust can distribute the capital gains made by the trust to beneficiaries, and these gains are then taxed as such in the hands of the beneficiaries rather than in the hands of the trust.

This proposal was first raised in the 2013 Budget Review, but it was not taken any further.

Van Vuuren says Fisa is of the view that such a measure will take a blunt instrument to a complex situation and will affect the not so wealthy as well as the wealthy.

Fisa instead proposed that a multi-point test be developed to identify those trusts where there is insufficient separation of control and enjoyment of the trust property, and special tax rules be applied to those trusts. The conduit principle should be retained for all bona fide trusts falling outside this group.

Brincker says many people who make use of trusts do so by way of interest-free loans.

He says the intention of the proposed amendments as outlined in the Budget Review is very unclear, but there would be little need to amend the Income Tax Act to deem an interest-free loan to be a donation, as there is already a Supreme Court case in which such a loan was held to be a donation.

CGT ON TRUSTS

Brincker says Treasury's proposals, as well as the increases in capital gains tax (CGT) for trusts, are likely to be very significant for the future of trusts.

If you have your assets in a trust, your inclusion rate for capital gains is currently 66.6 percent. This will increase to 80 percent on March 1.

Trusts are taxed at 41 percent, so the effective rate of taxation on capital gains will rise from 27.3 percent to 32.8 percent.

There are no exclusions for capital gains made in trusts and this makes an enormous difference between the CGT you pay on the sale of a home when you own it in your own name and when it is in a trust.

Van Vuuren says the impact of the increase in CGT will depend on the purpose for which the trust was formed and whether the conduit principle is maintained, allowing gains to the distributed beneficiaries to whom the CGT rates for individuals apply.

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