FISA

THE FIDUCIARY INSTITUTE OF SOUTHERN AFRICA

Comment on the Draft Taxation Laws Amendment Bill as published on 08 July 2016.

On 8 July 2016 the Draft Amendment Bills were published for public commentary. This Bill inter alia proposed the introduction of measures to prevent estate duty and donations tax avoidance through transfer of assets to a trust via interest free loans. Amongst others, a new section 7C is proposed, as well as amendments to section 56 of the Income Tax Act, 58 of 1962 (the "ITA"). An amendment is also proposed to section 11 of the Estate Duty Act, 45 of 1955 (the "EDA").

A. Executive Summary

1. With regard to the proposed section 7C of the ITA it is undesirable to approach a complex situation with a blunt instrument, especially while the work of the Davis Tax Committee is incomplete.
2. Trusts are not only used to avoid estate duty, but for a variety of reasons related to the protection of assets. In a significant portion of these cases the estate of the connected person extending an interest free loan to the trust would not be liable for estate duty in any event.
3. It is undesirable to use one tax (income tax) to prevent avoidance of another tax (estate duty).
4. Introducing the proposed section 7C in its current form necessitates revisiting the existing sections 7(3) to 7(10).
5. There are serious technical issues with regard to the wording of the proposed section 7C, as set out under B 1.4 below.
6. It is not clear whether the proposed section 7C is intended to apply to existing loans. If so, it would have grossly unfair and irrational results.
7. Applying the official rate of interest to loans between a connected person and a trust is inappropriate. The appropriate yardstick should be the yield on call money or what individuals would expect to receive in private loan transactions.
8. It is undesirable to amend the common law position with regard to interest on loans. It will also create absurd situations and unfair results, as set out in B 1.8 below.
9. Provision should be made for estate duty liability by person receiving death benefits under a retirement fund under section 37 C of the Pension Funds Act, 24 of 1956, where the provisions of section 3(2)(bA) of the EDA apply.

B. Comment on some proposals in the bill

1. Interest free loans to trusts

1.1. Legislation is applicable to trusts in general

The proposed new section 7C is clearly aimed at all instances where a connected person has extended a loan to a trust and is charging an interest rate on that loan which is below the official rate as contemplated in paragraph 1 of the 7th Schedule. The aim is clearly to prevent estate value pegging through the use of an interest free loan to transfer assets to a trust.

As discussed in the FISA Council's comments on the Davis Tax Committee's First Interim Report on Estate Duty, trusts are not exclusively used for the purpose of the avoidance of estate duty. Other uses include:

- The protection of assets for the benefit of children in the event of a second or later marriage or relationship with a person who is not the natural parent of such children. It is a well-established application of a trust to safeguard assets that the natural children of one parent would have realistic hopes to inherit from the, sometimes negative, influence of a further spouse or life partner;
- The protection of assets for the benefit of the elderly in cases where such persons fear dementia or other infirmity, and are afraid that such a condition will lead to a risk of exploitation if the person(s) have full control over their assets. A trust is an eminently useful vehicle in these circumstances to provide maintenance while the founder and spouse are alive, but protect the assets for the eventual heirs.
- The protection of assets where the asset is shared between members of an extended family.

In a large proportion of these cases the parties involved are not true high net worth individuals, but the only viable way for the original owner(s) of the asset(s) to make use of a trust is to sell the asset(s) on interest free loan.

In a substantial number of these cases, the estates of the sellers of these assets would not have been liable for estate duty in any event, and even more so if the Davis Tax Committee's proposal for a substantial increase in the standard abatement under section 4A of the EDA is implemented.

In the FISA submission to the Davis Tax Committee, the following was included:

> *The cases of abuse should rather be identified by way of a test based on the fundamentals of trust law as formulated in the Parker case. A precedent exists for this kind of multi-factor test, in par 57 of the 8th Schedule which deals with the requirements for a capital gains tax exclusion for small business owners upon retirement.*
>
> *Such a multi-factor test could include factors testing whether there is sufficient separation of control and enjoyment of the trust assets. Examples are whether the founder and/or his/her spouse are also*

> *trustees and beneficiaries, whether multiple trusts exist with the same beneficiaries, etc. Inadequate separation of control and enjoyment could then be visited with a higher tax rate or inability to utilise attribution.*
>
> *On this basis the abuse cases could then also be excluded from the provisions of paragraph 80 of the 8th Schedule.*
>
> *In a large percentage of the cases these structures would fall foul of an abuse test and will be susceptible to isolation and punitive tax treatment without harming the legitimate and desirable use of trusts.*

We submit that introducing the proposed section 7C would be to use a very blunt instrument in a complex situation, and resulting in collateral damage to parties for whom it was not intended.

1.2. Legislation introduces income tax measures to prevent estate duty savings

The proposed new section 7C introduces an imputed interest on loans by certain connected parties to a trust at an interest rate below the official rate of interest as determined in terms of the Seventh Schedule to the Act. However, it is abundantly clear from the wording of the Explanatory Memorandum that the only reason for this proposed new legislation is to prevent Estate Duty and donations tax avoidance through the transfer of assets to a trust using interest free or low interest loans. Clearly the proposed legislation is not aimed at Income Tax avoidance through interest free or low interest loans. If that was the case, it would make no sense to target only interest free or low interest loans to trusts for this purpose.

Bearing in mind the sole purpose of this legislation as set out above, it is not clear at all why the Legislator would think it fit to impute interest on interest free or low interest loans and subject such imputed interest to Income Tax. This will create cash flow problems where existing loans are concerned and where the trust does not earn income to pay the interest. The person who made the loan (possibly many years ago) will not receive any interest on the loan but he will still be liable for the tax on the imputed interest. Granted, he will be entitled to recover the tax paid from the trust, but if the trust has no income available in order to repay the tax, the cash flow problem will still exist.

If the sole purpose of the legislation is to curb the avoidance of estate duty by selling assets to a trust on interest free or low interest loans, surely this can be addressed by imputing growth on the loan account on an annual basis at a rate equal to the prescribed rate or the difference between the interest charged and the prescribed rate. This imputed growth should not be subject to Income Tax or Capital Gains Tax but will increase the loan account which will be subject to Estate Duty on the death of the person who made the loan. This will achieve the goal intended by this legislation without creating all sorts of cash flow problems. It makes much more sense to impute an increase in the value of the loan in order to ensure that the “evil” (at which this legislation is aimed) namely, transferring growth to a trust, is addressed without using another form of taxation (Income Tax) to curb the avoidance of Estate Duty***.***

1.3. What about existing section 7 & par 68 – 72 anti – avoidance provisions?

Section 7(3)–7(10) attaches a tax liability to a person who makes a donation, settlement or other disposition (hereinafter referred to as the “donor”). Section 7(3)–7(10) was introduced into the Act to combat different forms of tax avoidance. In the case of *CSARS v RM Woulidge* 2002 (1) SA 68 (SCA) it was held that the interest free element of a loan indeed constitutes a “donation, settlement or disposition” as envisaged in section 7. These sections have mirror images in paragraphs 68 – 72 of the 8th Schedule of the Income Tax Act which make the anti – avoidance provisions also applicable to capital gains realised as a result of a prior donation, settlement or other disposition.

If there is a loan payable by a trust to a Natural person or to a Company which is a connected party to that Natural Person (as envisaged by the new proposed section 7C), and no interest is levied on that loan, such loan will be subject to the anti-avoidance provisions (referred to above) and any income or capital gains accruing to the trust by reason of that “donation, settlement or other disposition” will be attributed to the “donor” (person to whom interest ought to have accrued if a market related interest was levied) but limited to the amount of a fictional market related interest. The computation of the fictional market related interest is required solely for the purpose of quantifying the amount to be attributed to the “donor”. It is clear that an amount of the income and or capital gains realised in the trust will be attributed to the donor and the trust will not be liable for tax on such attributed income and or capital gains.

The new section 7C will however result in imputing an additional taxable income (imputed interest) in the hands of the loan financier, without providing relief to the trust which owes the loan. And, should such interest indeed be levied there will be many instances where such interest, because of the nature of the income of the trust, will not be tax deductible. This might cause the trust capital to be eroded to a great extent.

Therefore, in the scenario where no interest is levied on a loan account owing by a trust, the person or entity to whom such loan is owed by the trust will not only be liable for tax on the attributed income and or capital gains, but he will also be liable for tax on an imputed interest. In effect a double taxation if both sets of legislation are to be applied simultaneously.

The question is whether the anti-avoidance provisions will apply if section 7C brings about an imputation of interest.

1.4. Technical mistakes in the proposed legislation

Subsection 7C(2)

Subsection (1) of the proposed legislation defines the type of loan to which section 7C would apply. It does not refer to the interest rate. Subsection (2) contains certain limitations regarding losses, deductions or allowances that may be claimed, but refers to a loan, advance or credit referred to in subsection (1). This would mean that any loan, whether at arm's length or at the official interest rate (or not) will still fall foul of subsection (2). Surely this could not be the intention. Subsection (2) should be amended to refer to a loan, advance or credit referred to in subsection (1) read with subsection (3).

Subsection 7C(5)

In terms of subsection (5), section 56 (2) of the Act will not apply in respect of any amount owing in respect of a loan, advance or credit contemplated in subsection (1) that is disposed of under a donation. It is not clear why this limitation must be applied only as far as trusts are concerned considering that a person can limit the growth in his estate by making donations to any other person or company (which donations will still qualify for the exemption in terms of section 56 (2)). Be that as it may, the wording of subsection (5) includes any loan as defined in subsection (1) whether market related interest is charged on the loan or not. Again, subsection (5) should be amended to refer to a loan, advance or credit contemplated in subsection (1) read with subsection (3).

1.5. Applicable to existing loans receivable

The wording of the proposed section 7C refers to "*…directly or indirectly* ***makes*** *or* ***provides*** *any loan, advance or credit to a trust in relation to which that person or company, or any person that is a connected person in relation to that person or company, is a connected person.*" (our emphasis).

We interpret this to mean that formal loans already in existence on 1 March 2017 will not fall under the provisions of the section. If this is the intention with the proposed amendment, and subject to our views expressed under 1.1 above, we agree that this is appropriate.

We submit that, although a loan agreement may be open-ended with no fixed term, that fact alone cannot support an argument that the loan is renewed on an annual basis and becomes a new agreement every year. The consensus between the parties, forming the basis of the agreement in such a case, is undoubtedly that the loan is entered into as one agreement which is effective from the date of the agreement to the date when it is terminated by being called up by the lender or in some other way.

In the absence of an interpretation that the loan is renewed every year, it would be grossly unfair and irrational to penalise taxpayers who entered into a perfectly legitimate agreement with the onerous tax implications referred to above.

Legislation in general, and tax legislation in particular, should not be retro-active except in exceptional circumstances.

If legislation comes into operation retrospectively or retroactively, it conflicts with the rule of law which is entrenched in Section 1 of the Constitution of South Africa. One of the applications is that one should be able to know the law in order to arrange one's affairs accordingly.

In *President of the Republic of South Africa v Hugo, 1997 (4) SA 1 (CC),* it was held that:

> The need for accessibility, precision and general application flow from the concept of the rule of law. A person should be able to know the law, and be able to conform his or her conduct to the law.

If tax laws are applied retrospectively or retroactively tax payers are not put in a position to arrange their financial affairs accordingly, which could result in unexpected liquidity problems.

1.6. Application of the official rate of interest

We submit that using the official rate of interest is inappropriate to determine a deemed income in the hands of the lender.

The aim of the official rate of interest is to prevent income tax leakage in the employment situation by preventing the extension of soft loans in lieu of remuneration.

If the lender would lend an amount to anybody s/he knows well and trusts, the interest rate would probably be in the region of the repo rate or less, making provision for the fact there will be no bank or "middle man" in the equation who needs to make a profit. In reality this is not limited to loans between connected persons.

1.7. Distributions to trust Beneficiaries also implicated?

A practice has developed amongst certain accountants to treat distributions to trust beneficiaries, which are held back by trustees under powers granted to them under the trust instrument and not paid out to the beneficiary, as loans by such beneficiaries to the trustees in their capacity as joint owners of the trust property and reflect it as such in the financial statements of the trust in question.

It is trite law that a loan is a bilateral legal agreement between a lender and a borrower and requires consensus between the parties.

We submit that, in the absence of consensus between the trustees on the one hand and the beneficiary(s) on the other, such a distribution which is not paid out cannot be a loan. In its pure form such a withheld distribution is done unilaterally by one party (the trustee(s)) under powers granted in the trust instrument without requiring the reaching of consensus with the beneficiary. We submit further that very good reasons could exist for such a withheld distribution, e.g. where distributions are made to a class of beneficiaries and one or more members of the class is financially not sophisticated enough to receive it in cash or in the form of the particular asset in question.

Such a distribution will imply that vesting of the distribution has taken place and that the vested income or capital is now the property of the beneficiary. This may be subject to conditions, but in general will imply that any future income or capital gain will be for the account of the beneficiary and should be treated as such for tax purposes. However, in these circumstances, such a withheld distribution can never be regarded as a loan extended by the beneficiary.

It may be the case that these powers are sometimes abused to enable the exploitation of a tax advantage. In our submission, when there is consensus required or when a formal agreement is entered into between trustees and beneficiary, it crosses the line and does become a loan.

Should the proposed section 7C be promulgated in its current form, we submit that the SARS would be duty bound to acknowledge the different situations and issue an appropriate practice note.

1.8. The levying of interest or not on a loan is a contractual term to be determined by the contracting parties

In South African law a loan does not bear any interest unless explicitly specified. This common law position should not be tampered with lightly as doing so is bound to lead to absurdities and may have unintended consequences.

As submitted in 1.1 above, we hold the view that the cases of trust structure abuse purely to obtain a tax advantage should be separated from the cases of use of trusts for asset protection purposes. We believe that our submission to the Davis Tax Committee on how to go about this is a viable solution, as quoted in 1.1 above.

It is submitted that the proposed section 7C will destroy tax neutrality between a loan to an individual without specifying interest, and a loan to a trust for the benefit of that individual. Nothing prevents a taxpayer to extend an interest free loan to a major child who starts out in life. In the appropriate circumstances, where there is no possibility of the amount involved ever attracting estate duty in the estate of the lender, it seems grossly unfair to make it financially impossible to use the protection advantages of a trust just to be in a position to prevent estate duty avoidance by someone else. This is especially true in circumstances where other measures to identify the abusers of such structures are possible.

2. Proposed amendment to section 11 of the Estate Duty Act, 45 of 1955.

We understand this to be an amendment to rectify an oversight to delete subparagraph (iA) of paragraph (b) of section 11 when section 3(3)(a)*bis* was deleted in 2009, and on that basis support the proposed amendment.

We submit that a further amendment to section 11 was necessitated by the introduction of section 3(2)(bA) in 2015, but was not part of the Taxation Laws Amendment Act, 2015.

Section 3(2)(bA) includes in property in the estate of a deceased person:

"so much of the amount of any contribution made by the deceased in consequence of membership or past membership of any pension fund, provident fund, or retirement annuity fund, as was not allowed as a deduction in terms of section 11 (k) or (n) of the Income Tax Act, 1962 (Act No. 58 of 1962), or paragraph 2 of the Second Schedule to that Act or, as was not exempt in terms of section 10C of that Act in determining the taxable income as defined in section 1 of that Act, of the deceased;"

Firstly, we submit that this amount does not bear any relation to any real amount received by any dependant of or beneficiary nominated by the deceased as contemplated by section 37C of the Pension Funds Act, 24 of 1956 and, as such, should not be included under section 3(2) of the EDA but rather under section 3(3) as deemed property;

Secondly, it seems grossly unfair that any duty that can be ascribed to the inclusion of this "property" be borne by the estate and therefore effectively the heir(s) of the residue and not by whoever receives the benefit under the mentioned section 37C. Section 11 does not make provision for anyone other than the executor to be liable for payment of this duty.

In our opinion it would be preferable that the EDA be amended to move subparagraph (bA) to subsection (3) of section 3 and to include a reference to the subparagraph in section 11(b)(i) or in a new 11(b)(iA).

C. Concluding remarks

It seems strange that the proposed measure to visit the extension of an interest free loan to a trust with a punitive tax liability is part of draft legislation while the Davis Tax Committee is still busy with its work. After the publication of the First Interim Report on Estate Duty and the public participation process, the outcome of that is still awaited.

We submit that it is undesirable to approach the highly complex area of estate duty, donations tax and capital gains tax at death in such a piecemeal fashion before the work of the Davis Tax Committee has been finalised. We are also hard pressed to find another instance like this rare one where one tax (income tax) is utilised to prevent avoidance of another tax (estate duty).

We thank you for the opportunity to submit these comments

Yours faithfully

For the FISA Council

5 August 2016