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REGULATORY DEVELOPMENT 2016

INTEREST FREE OR LOW INTEREST LOANS TO TRUSTS

One of the main proposals in the 2016 Budget speech was the introduction of measures to prevent (perceived) tax avoidance through the use of trusts. This is to be achieved by way of a proposed new section 7C in the Income Tax Act, which section was introduced in the Draft Taxation Laws Amendment Bill, 2016 ("DTLAB") published in July. Significant changes were made to the section in the Draft Taxation Laws Amendment Bill, 2016 (Second batch) ("DTLAB2") published in September, which includes certain exemptions.

The provisions of the section will apply a **loan, advance or credit made by a natural person**, or **by any company in relation to which that person is a connected person** (*i.e. any person who individually or jointly with any connected person in relation to himself holds directly or indirectly at least 20% of the company's equity share capital or voting rights*) to a **trust in relation to which that person or company is a connected person** or to **a trust in relation to which any person that's a connected person to that person or company, is a connected person** *(i.e. a beneficiary of a trust, any relative of such beneficiary, any other beneficiary of such a trust)* and n**o interest is charged** in respect of the loan, advance or credit, **or interest is charged at a lower rate than the official rate of interest** contemplated in paragraph 1 of the Seventh Schedule to the Income Tax Act (currently 8%).

The section is set to come into operation on **1 March 2017** and will apply in respect of **any amount owed by a trust in respect of a loan, advance or credit provided to the trust before, on or after that date**.

Consequences under DTLAB

! A**n amount equal to the difference** between the amount incurred by the trust as interest on the loan in respect of the year of assessment and the amount that would have been incurred by the trust had interest been levied at the official rate of interest **will be included in the income of the person making the loan**.

! The imputed interest will **not** qualify for the **interest exemption** set out in section 10(1)(i) of the Income Tax Act in the hands of the trust.

! The lender could recover from the trust an amount equal to **the difference between the amount of normal tax that would have been payable by the person** in respect of the year of assessment **and the amount payable by that person after inclusion of an amount in terms of this section**. Should he fail to do so within a period of three years, that amount will be **treated as a donation by that person to the trust after the period of three years** and be taxed as such.

! The provision of section 56(2) of the Act exempting donations up to an amount of **R 100 000 will not apply to a loan, advance or credit as contemplated in this section that is disposed of**

under a donation. The practice of writing off **R100 000** per tax year on the loan free of donations tax will therefore **not be available**.

Consequences under DTLAB 2

! An **amount equal to the difference** between the amount incurred by the trust as interest on the loan in respect of the year of assessment and the amount that would have been incurred by the trust had interest been levied at the official rate of interest **will be treated as a donation made to the trust, and will be subject to donations tax at a rate of 20%,** on the last day of the year of assessment, by the person who made the loan to the trust.

! T**he annual donations tax exemption of R100 000** can be applied to determine the amount of donations tax payable above or it can be used to reduce the value of the outstanding loan.

! The **attribution provisions contained in Sections 7(5) and 7(8) and Paragraph 70 and 72** will apply as a result of the ongoing annual donation.

! **No deduction, loss, allowance or capital loss may be claimed** in respect of:

- a disposal, including by way of reduction or waiver; or
- the failure wholly or partly of a claim of the payment, of any amount owing in respect of a loan, advance or credit referred to above.

! If a loan, advance or credit was provided **by a company to a trust at the instance of more than one person** that is a connected person in relation to the company, each of those persons will be treated as having donated to the trust the part of that amount that bears to that amount the same **ratio** as the equity shares or voting rights in that company that were held by that person during the year of assessment bears to the equity share or voting rights in that company held in aggregate by those persons during that year of assessment.

Exemptions

The provisions do **not apply** if:

! The trust is an approved **Public Benefit Organisation**;

! The loan, advance or credit was provided to the trust **by a person by reason of, or in return, for a vested interest held by that person in receipts and accruals and assets of that trust** and;

! The beneficiaries of the trust hold in aggregate a vested interest in all the receipts, accruals and assets of the trust;

- No beneficiary can in terms of the trust deed hold or acquire an interest in the trust other than a vested interest as envisaged above;
- The vested interest of the beneficiary is determined solely with reference and in proportion to the assets, services or funding contributed by that beneficiary to the trust and;
- None of the vested interest is subject to a discretionary power conferred on any person in terms of which that interest can be varied or revoked.

! The trust is a **special trust as defined in paragraph (a)** of the definition of a special trust (*i.e. a trust solely for the benefit of one or more persons who are persons with a disability, where such disability incapacitates such person or persons from earning sufficient income for their maintenance, or from managing their own financial affairs*);

! The trust used the loan **wholly or partly** for purposes of funding the acquisition of an asset, **which asset was used**, throughout the year of assessment, by the person granting the loan or the spouse of that person, **as a primary residence** (as defined in the Income Tax Act) and the amount owed relates to the part of the loan, advance or credit that funded the acquisition of that asset;

- The loan, advance or credit constitutes an **affected transaction as defined in section 31(1)** that is subject to the provisions of that section (*transfer pricing provisions*);
- The loan, advance or credit was provided to the trust in terms of a **Sharia compliant financing arrangement**;
- **The loan, advance or credit is subject to the provisions of section 64E(4)** (*i.e. where the loan was made to the trust by a company and is deemed to be a dividend by that company to the trust in terms of the said section*).

Comment

At this stage there is still a degree of uncertainty around some of the provisions of section 7C, in particular whether the provisions will apply where the trustees, in terms of the discretionary powers given to them in the trust deed, credit distributions to a beneficiary on loan account on behalf of such beneficiary. The general view is that the ensuing loan account does not constitute a loan as envisaged as there is no contract of loan between the beneficiary and the trustee, but there is not yet clarity on whether Treasury holds the same view.

Although this section will still have an effect on the use of trusts for estate planning purposes, the changes have to be welcomed. Each trust will have to be considered on its own merit in order to determine the most tax efficient way forward. If the trust earns taxable income, it would at least be a consideration to pay interest on the loan account since the trust would be able to deduct the interest for tax purposes.

While these new provisions will affect the use of trusts in estate planning, it needs to be noted that it is still in draft format and we await the final legislation.

DAVIS TAX COMMITTEE SECOND (AND FINAL) INTERIM REPORT ON ESTATE DUTY

The Davis Tax Committee (DTC) published its second and final report on estate duty on 24 August 2016, after taking into account submissions from the public (including FISA) on the first interim report. The report contains several **recommendations**, but this article focuses on the recommendations relating to trusts and estate planning.

- **The interspousal abatement** [section 4(q)] should be withdrawn and replaced with a substantially enhanced primary abatement, to ensure the consistent equitable treatment of all taxpayers.
- **The primary abatement** [section 4A] should be increased to R15 million per taxpayer, irrespective of marital status.
- **The estate duty rate** should be increased to 25% of the dutiable value of an estate exceeding R30 million.
- **The capital gains tax** rollover provisions for interspousal bequests should be repealed and replaced with a death exemption of R1 million.
- **The interspousal donations tax** exemption should be removed, except for an exemption for the reasonable maintenance of the taxpayer and his/her family.
- The **section 56(1)(c)** exemption should be removed.
- The transfer of assets in terms of a **divorce** order should be subject to exemptions similar to those of the death benefit as regards estate duty and CGT. The taxpayer's death benefit

abatements or subsequent divorce abatements will be reduced by the quantum of allowances claimed during the taxpayer's lifetime.

! SARS should establish comprehensive records of all **bare dominium and trust arrangements**. This should include the requirement that all holders of such interests in property be required to submit tax returns irrespective of income levels.

! National Treasury should consider extending the provisions of **section 3(3)(d) of the Estate Duty Act** to include 'deeming' provisions that identify 'deemed control' of a trust through a loan account between a trust and 'a connected person(s)', where the loan is not subject to interest or is subject to interest at a rate below the official rate. In these circumstances the loan provides the lender with de facto control over the trust.

! All **trust arrangements** should be examined by SARS on registration and on transfer of assets into trusts. This should reduce aggressive tax planning and, at the same time, provide a level of assurance to tax payers that their affairs are in order.

! Further investigation should be conducted into the implementation of **wealth taxes**. This will be addressed in a separate report of the DTC during 2016.

! Donors and beneficiaries of all **vested trust** arrangements should be subject to stricter disclosure requirements and enforcement measures. SARS should develop risk-profiling analysis to identify and examine trust arrangements and the estate duty assessment procedures of SARS should concentrate on the examination of trusts in which the deceased may have enjoyed a vested interest to ensure that all income and capital have been brought into account for both income tax and estate duty purposes.

  ! **Discretionary trusts**: only where a trust deed confers on its beneficiaries an indisputable and irrevocable vested right to both the capital and income of a trust, should the income, both capital and revenue, be taxed in the hands of the beneficiary.

  ! In **all other trusts**, **revenue income** must be taxed in the trust in accordance with the definition of 'gross income' contained in section 1 of the Income Tax Act (ITA) and **capital income** generated while assets are held in trust on a basis other than a vested basis, must be taxed within the trust up to the time of vesting or disposal as defined in paragraph 11 of the Eighth Schedule to the ITA.

  ! The **flat rate** of income tax applied to trusts should be retained at its current level and be subject to adjustment in line with changes in the maximum personal income tax rate.

! The comprehensive examination of **foreign discretionary trusts** should not be confined to the application of the ITA when vesting or distribution occurs. SARS should also examine the substance of arrangements before vesting or distribution and should also establish a separate investigation unit to examine foreign trust arrangements thoroughly and comprehensively. Where disclosure deficiencies are detected, the penalty provisions of the Tax Administration Act of 2011 (TAA) should be rigidly applied.

! **Offshore retirement funds** should be further investigated by SARS.

The above recommendations by the DTC were submitted to the Minister of Finance. The Minister will consider the recommendations and will make any appropriate announcements as part of the normal budget and legislative processes. Until this happens, these are recommendations only and care needs to be taken when assisting clients with planning.

Ronel Williams, FISA Chairperson
On behalf of FISA Council
3 October 2016