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How new regulation to curb tax avoidance could affect trusts

Treasury softens its stance on interest-free loans

By: INGÉ LAMPRECHT

NATIONAL TREASURY has significantly revised its initial proposal to curb the avoidance of estate duty by moving assets to a trust, but planners who believe that trusts are the panacea for everything related to financial planning will have to reconsider their stance.

President Jacob Zuma signed the Taxation Laws Amendment Bill into law on 11 January 2017. As a result of the new regulations, it could soon become far less favourable from a tax perspective to move assets to a trust and extend an interest-free or low-interest loan to the vehicle to finance the transaction.

This practice, which has been widely used as an estate planning exercise, allows the assets to grow in value outside the estate of the original owner, effectively reducing estate duty income for the fiscus. National Treasury's initial proposal was to curb the practice by charging income tax on the deemed interest, but industry commentators were highly critical of the suggestion, with some arguing that it was draconian.

Following consultation with industry, Treasury softened its stance. When the revised Section 7C of the Income Tax Act takes effect on 1 March 2017, any loan to a trust by someone who is a connected person to the trust (usually the founder, trustees, or beneficiaries) that does not bear interest at least equal to the official rate of interest in the Seventh Schedule of the Income Tax Act (currently 8%) will be deemed a donation on the last day of each tax year that the loan remains outstanding. The donation will be equal to the difference in the interest payable on the loan and the official rate.

Louis van Vuren, CEO of the Fiduciary Institute of Southern Africa (FISA), explains that if someone extends an interest-free loan to a trust of which he or she or any of his or her children are beneficiaries, the loan would be deemed to accrue interest at 8% per annum. Thus, if an interest-free loan of R1 million is extended to the trust by such a person, the lender will be deemed to have made a donation to the trust on the last day of the tax year of R80 000 ((R1 million x (8% minus 0%)), because no interest was in fact charged or paid.

However, because the annual donations tax exemption of R100 000 will apply, the lender won't be liable for donations tax unless the loan exceeds R1.25 million (while the official rate remains at 8% per annum), provided that the person didn't make any other donations during the year.

New as well as existing loans are affected.

Van Vuren says that while the that industry would have to wait and see where trust regulation is going, the new regulations are clearer and much more acceptable than the first draft proposal—but where do the new regulations

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leave estate planners, who often advised clients to move growth assets to a trust by way of an interest-free loan to limit estate growth and (consequently) the estate duty payable upon death?

Van Vuren says that depending on the size of the loan, planners won't be able to reduce the outstanding balance of the loan without paying donations tax. For example, if the founder of a trust extended an interest-free loan of R2 million to the trust ten years ago and donated R100 000 per annum to the trust to reduce the loan (the loan would have reduced to R1 million by now), from 28 February 2018 the founder will be deemed to have made a donation of R80 000 to the trust on the last day of the tax year, leaving only R20 000 of the R100 000 annual donations tax exemption to donate to the trust without having to pay donations tax.

Whether the new regulations will significantly reduce the use of this type of estate planning structure will depend to a large degree on the growth potential of the assets intended to be kept in trust, Van Vuren says. "If the growth potential exceeds inflation by a substantial amount, then it would still make sense to make use of that scheme."

However, the new provisions will make people think twice before moving assets into a trust, except in cases where trusts are explicitly excluded from the regulations. Investment trusts (where the lender holds a vested right in the trust assets corresponding *pro rata* with the loan), public benefit organisation trusts, special trusts for mentally or physically handicapped people, as well as trusts where a primary residence was transferred by way of an interest-free loan, are exempt from the Section 7C provisions.

Some technical areas are also explicitly excluded.

"We will have to see how this pans out, but we could see a reduction in the number of trusts that are set up, which personally I don't think is necessarily a bad thing. There have been a number of cases in the past where a trust was not necessarily the right planning solution for the client, but at some stage in the past, trusts became the flavour of the month. In some cases people set up trusts left, right, and centre in circumstances where it was not necessarily an appropriate estate planning solution. There were even operators who said that you should have at least three trusts—which could be appropriate advice in certain specific circumstances, but is definitely not a general rule."