

The funding of a Trust – a shifting tax landscape

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Background and rationale to section 7C

- the incentive behind the enactment of section 7C was the lawful avoidance of estate duty and donations tax where a person sells assets to a Trust and the sale of those assets is financed *via* an interest-free loan or a loan bearing interest at below the Official Rate of Interest (ORoI)
- donations tax would not be triggered where the asset was sold at market value to a Trust  gratuitous disposal
- section 7C is intended to counter such arrangements focusing on interest-free loans or loans bearing interest at below the ORoI where such loans are made, directly or indirectly, by a natural person who is a connected person in relation to the Trust, or by a company that is a connected person in relation to that person

Background and rationale to section 7C cont...

- rationale was to *tax* interest rate difference
- original proposal was to (income) tax difference as imputed interest in the hands of the lender, with subsequent donations tax consequences - if lender did not recover such tax from the Trust within 3 years the income would be treated as a donation
- DTC proposed not implement *transfer pricing regulations* rather amend of section 3(3)(d) of the Estate Duty Act to include deeming provisions that identify *deemed control* of a Trust, along the following lines
 - loan between a Trust and a connected person
 - Interest free / low interest (ORoI)
 - demand repayment
 - lender will be deemed to be *in effective control* of the Trust and section 3(3)(d) will be deemed to apply

Introduction and Overview

- anti-avoidance measure = deficiency in the donations tax rules, interest free loans not technically donations
- section 7C applies to any **loan, advance or credit provided, directly or indirectly (01 March 2017)**
 - ❖ by an individual or
 - ❖ by a company at the instance of an individual (cp 20%)

to either a

 - ❑ Trust where the Trust is connected to the natural person
 - ❑ company where 20% shares are held by the Trust

Introduction and Overview cont...

- section 7C also applies to a loan advanced by an individual to a company if at least 20% of its voting rights can be exercised or 20% of its equity shares are held (directly or indirectly) by the Trust referred to above whether alone or with a beneficiary (or spouse or relation within the 2nd degree of consanguinity of the beneficiary or spouse) of that Trust
- essentially, the intent clearly is to affect any loans made to a company substantially owned or influenced by a Trust

Section 7C: present day legislation

- if a natural person –
 - directly or indirectly provides a loan, advance or credit
 to a Trust –


and is a connected person to the Trust


or is a connected person to any other person which is a connected person to the Trust

Section 7C: present day legislation

- if a Company –
 - directly or indirectly provides a loan, advance or credit

 to a Trust

 at the instance of a natural person

 that natural person holds minimum 20% equity shares or voting rights

 and the natural person or the company is a connected person in relation to the Trust

Section 7C: present day legislation

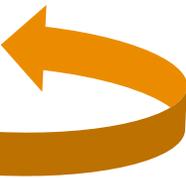
- if a natural person –

- directly or indirectly provides a loan, advance or credit

 to a company

 of which a Trust holds* minimum 20% equity shares or voting rights

 the natural person is a connected person or
a connected person in relation to the natural



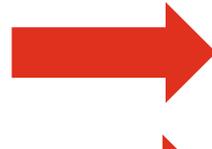
* To determine holding of Trust, consider the Trust, beneficiaries of the Trust, the spouses or beneficiaries and relatives or a beneficiary/spouse of a beneficiary to the 2nd degree of consanguinity

Section 7C: present day legislation

- if a Company -
 - directly or indirectly provides a loan, advance or credit

 to another company (borrower)

 at the instance of a natural person

 of which the natural person holds** minimum 20% equity shares or voting rights (providing the loan)

 and a Trust holds* minimum 20% equity shares voting rights in that company (borrower)

 and the natural person or the company is a connected person in relation to the Trust

* *To determine holding of Trust, consider the Trust, beneficiaries of the Trust, the spouses or beneficiaries and relatives or a beneficiary/spouse of a beneficiary to the 2nd degree of consanguinity*

** *Individually or jointly with connected person*

Section 7C - *post* changes since inception

- where a person acquires a claim against an amount owing by a Trust or company in respect of a loan, advance or credit
 - person deemed to have provided that loan
 - section 7C will apply to that person

section 4(q) *vis-à-vis* section 7C



Exemptions

- PBO's (30(3)) and Small Business Funding Entities (30C)
 - special Trust
 - primary residence
 - TP provisions (31)
 - Sharia Law
 - deemed dividends (64E)
 - employee share incentive schemes
 - in return for vested interests (subject to *proviso's*)
- and**
- what about trustee vestings not distributed / paid to beneficiaries –
 - BPR 350
 - EP 2016

Implications of section 7C

- interest free / low interest - ORol



difference between actual and ORol deemed a donation
deemed a donation on last day of the YoA
subject to donations tax

- R100,000? – IT/IB144
- if the loan is disposed of, waived, reduced or not repaid (wholly or partly) following a claim for payment



may not claim a deduction, loss, allowance or capital loss

Implications of section 7C cont...

- loan advanced by company at instance of more than one person -



deemed donation by each of those persons



total donation still the total shortfall in interest – refer previous slide



pro rata determination of each person's donation

- equity shares / voting rights per person as percentage of the total equity shares / voting rights held by the persons at whose instance the loan, advance or credit was provided

Recent Developments: BPR 350

- binding private ruling 350, 26 August 2020 determines the tax consequences of the vesting of a capital gain in a beneficiary where the payment of the capital gain is deferred at the discretion of the trustees and the capital gain is invested on behalf of the beneficiary
- the ruling declared that paragraph 80(2) of the 8th Schedule of the Income Tax Act will apply and the capital gain must be disregarded for the purpose of calculating the aggregate capital gain or loss of the Trust and must be taken into account for the purpose of calculating the aggregate capital gain or loss of the beneficiary
- the ruling also concluded that section 7C of the Income Tax Act will not apply to the proposed transaction in that the deferred enjoyment by the beneficiary of the capital gain will not be construed as a loan made by the beneficiary to the Trust

Section 7C: Preference Shares – Latest Developments

- TLAB tabled during October 2020 - definition of a loan, credit or advance has been widened to include *preference shares* issued to the natural person by a company



subscription price of preference shares will be deemed to be a loan advanced



dividends in respect of those preference shares shall be deemed to be interest in respect of such a deemed loan

Section 7C: the nonsensical aspect

- when section 7C was amended in 19 July 2017, the provision was extended to include a loan made by an individual to a company in which such a Trust (***or a beneficiary of such a Trust***) holds at least 20% of the equity shares (directly or indirectly) or is able to exercise 20% of the voting rights



the inclusion of the beneficiary has had the result of skewing the initial intention of the introduction of section 7C in that a literal interpretation of this piece of legislation has had the effect of adversely affecting legitimate transactions in which a Trust has no interest

Section 7D and the 'in duplum' rule

- section 7C is supported by section 7D
- section 7D stipulates that section 7C's anti-avoidance rules should apply in spite of the application of the 'in duplum' rule
- the 'in duplum' rule can be defined as the amount of any interest, fee or similar finance charge cannot in aggregate exceed the amount of the principal debt. This means that no interest may accrue or be incurred in respect of a debt once such interest is equal to the capital amount of the debt  *common law rule must be ignored!!*
- section 7D(b)  *simple interest calculated daily!!*

Connected persons: illustrative examples

- definition of connected persons as per ITA
- A and B are equal shareholders of Opco. A's shares are held in his Family Trust, but B owns her shares in her personal capacity. Will section 7C be applicable in the following scenarios?



Scenario 1: A lends money interest-free to his Family Trust -

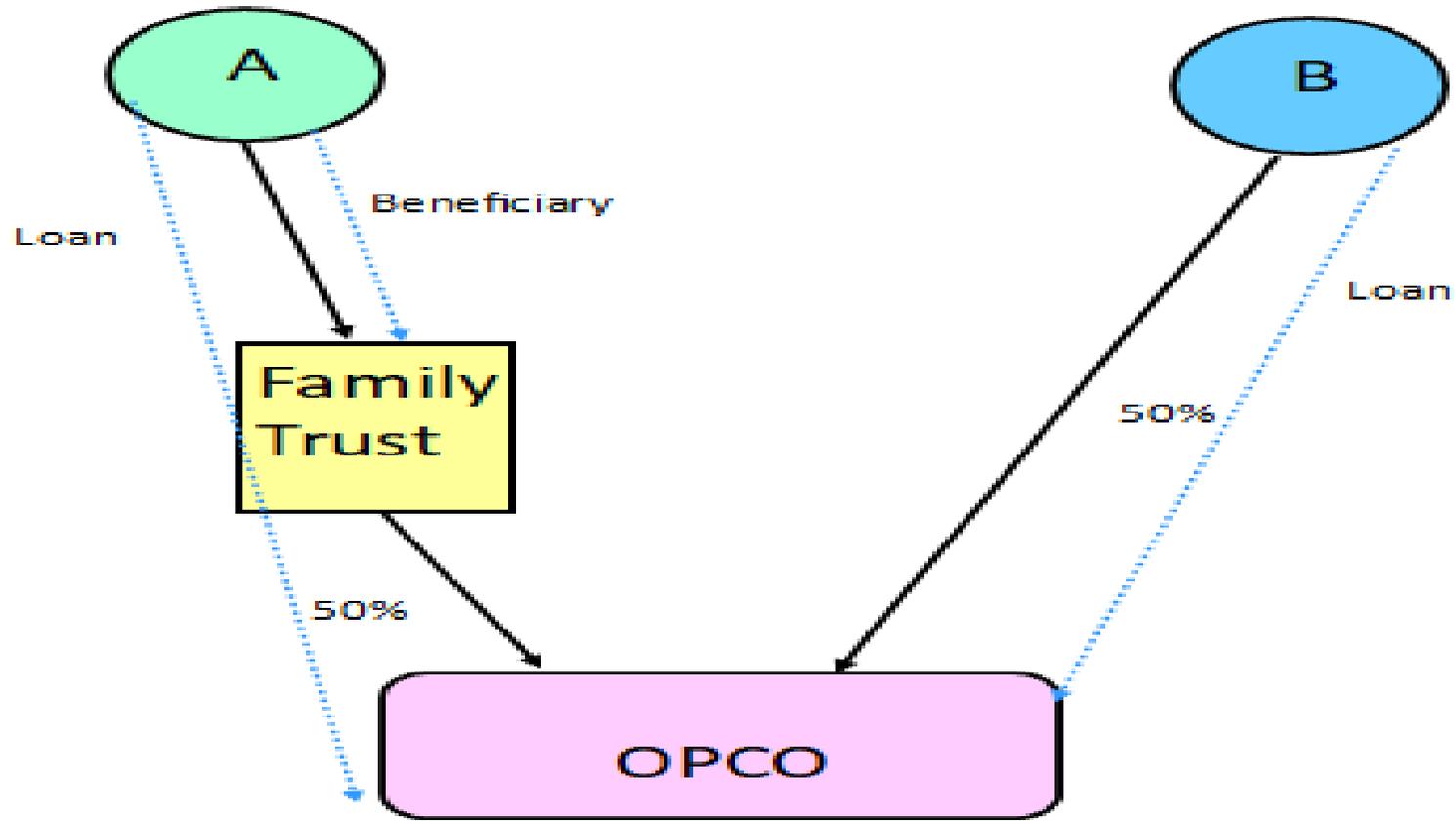


Scenario 2: A lends money interest-free to Opco -



Scenario 3: B lends money interest-free to Opco -

Connected persons: illustrative examples



Connected persons: illustrative examples

scenario 1: - A lends money interest-free to his Family Trust -



because A is a beneficiary of the Family Trust, they are connected persons in relation to each, resulting in any interest-free loan granted by A to the Trust being subject to section 7C

Connected persons: illustrative examples

scenario 2: - A lends money interest-free to Opco -



because the Family Trust owns at least 20% of the equity shares in Opco and A is a connected person to the Family Trust because he is a beneficiary, it can be said that A is a connected party to Opco. This results in any interest-free loan granted by A to Opco being subject to section 7C because A together with the Family Trust own at least 20% of the equity shares of Opco.

Connected persons: illustrative examples

scenario 3: - B lends money interest-free to Opco -



definition of CP does not contain a paragraph which establishes a relationship between persons that hold shares in the same company by reason of their holdings in that company



the fact that A and B both hold shares in Opco does not make A and B CP in relation to each other



B is a CP to Opco because she owns at least 20% of the equity shares in Opco



however, because A and B are not CP, there is no link between B and a Trust



this results in the loan from B to Opco not being to subject to section 7C

Connected persons: illustrative examples

scenario 3 continued -



a CP relationship may, however, be established between holders of shares in the same company because of some other relationship. For example, such a relationship may exist because the holders are relatives, members of the same partnership or beneficiaries of the same Trust



in this example, had A and B been married, they would not be CP in relation to each other because of their holding of shares in Opco. They would, however, be CP in relation to each other because they are related to each other by virtue of their marriage

Connected persons: illustrative examples

scenario 3 continued:



Because A and B are CP, this would result in a link between B and A's Family Trust as A is a beneficiary of the family Trust.

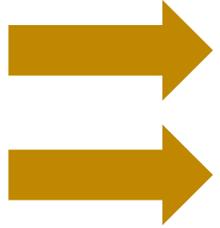


The result is that B and its connected party (i.e., the Trust) owning at least 20% of the equity shares in Opco.



B would be subject to section 7C and would be liable to pay donations tax on the interest not levied on the loan from B to Opco

Deemed interest calculations



deemed interest calculated on a daily basis

averaging

Example

Y lent R3m to the Y Trust on 1 March 2018. On 30 June 2018, the Trust repaid R1m of the loan. The loan was interest-free. At 28 February 2019, R2m of the loan was outstanding. Assume the ORoI was 8% but changed to 7.75% effective 1 August 2018

Deemed interest calculations cont...

the deemed interest on the loan for the year ended 28 February 2019 is calculated as follows

R3 million x 8% x 122/365	R80,219
R2 million x 8% x 31/365	13,589
R2 million x 7.75% x 212/365	90,027
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Total interest	R183,835

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