Response to the Draft Taxation Laws Amendment Bill relating to taxation of trusts:

Clause 12: insertion of new section 7C - "Loan or credit advanced to trust by connected person"

Proposed amendment

The new provision seeks to discourage the use of interest-free loans to trusts by founders, which have been identified as a means by which Estate Duty is avoided by such persons (or rather, by their estate at death). The new provision will deem interest to be charged on these loans at the official rate, and further deem a donation to have occurred if the tax on the interest is not recovered from the trust. Finally, it seeks to prevent the annual donations tax exemption from being used to pay down such loans.

As presently drafted, the provision appears to apply only to loans and credit advanced after 1 March 2017, as would be fair and expected, however this should be clarified in the final EM.

Problems identified and proposed solutions

Benevolent trusts

Most trusts are established for reasons other than the avoidance of income tax and Estate Duty. This fact is not recognised in the proposal. Trusts established for charitable purposes, the protection of assets for the benefit of minors or the elderly, the maintenance of former spouses and children, and many other benevolent trusts, will be fatally impacted by this proposal. Many of these trusts will not earn the official rate of interest (currently 8%) and will be unable to pay the required interest, nor pay the lender the tax due on the interest. The trust would quickly become insolvent and be unable to achieve its benevolent objectives. Furthermore, the trustees of such trusts would find themselves in the position of having to find a return of at least 8% on trust assets in order to ensure the survival of the trust, forcing them to take investment risks that put the trust in further jeopardy. Tax rules should not drive these outcomes.

Solution

It is admitted that a carve-out or exemption for benevolent purpose trusts would be difficult to define. Consequently, it is submitted that a less punitive proposal be put forward to discourage Estate Duty avoidance, and that this proposal be removed in its entirety until a solution is found.

Commercial trusts

The proposal is clearly aimed at family trusts funded by individuals, or by their family companies. However, the scope of the provision is so far reaching that it could easily impact many commercial

arrangements where a company loans funds to a trust, including BEE empowerment trusts, employee share trusts, and asset protection trusts. The trigger is merely that the company be connected to an individual who is connected to the trust. The definition of "connected person" in section 1 is notoriously wide, so that even large companies could find that certain individuals are connected to the company and the trust, for example because they are beneficiaries of the same trust or partners of the same partnership.

Solution

The trigger should be narrowed to ensure that only family trusts are targeted. Perhaps consider using a narrower version of the "connected person" definition.

Attribution rules and CGT

A low or interest-free loan is considered an "other disposition" for the purposes of the attribution rules (i.e. section 7, and Part X of the Eighth Schedule), in terms of the common law. Therefore, failure to charge interest on the loan already triggers these "tax back" rules. The lender will consequently pay income tax and capital gains tax on any income and gains generated in the trust by funds from the interest-free and low-interest loan. This is fair and proper, and it is suggested that SARS should enforce these provisions more vigorously, in order to discourage the abuse of trusts in this way.

There is nothing in the proposal which would prevent both section 7C and the attribution rules from applying to the same loan. An interest-free loan remains an "other disposition" even if section 7C deems interest to be taxable on it. This will result in double taxation.

Furthermore, the disposal of assets into a trust on loan account will trigger CGT, as would be the case for any asset disposed of by an individual. Such tax is not avoided by the use of an interest-free loan to fund the transfer.

Solution

Interest-free loans do not achieve income tax or CGT avoidance, if the attribution rules are properly enforced. Although transfer of assets diminishes the estate of the disposer, CGT is paid thereon, so there is no avoidance. Furthermore, the loan is an asset in the estate of the lender, on which Estate Duty will be paid at death. The only loss to the *fiscus* is Estate Duty on the subsequent growth, if any, of the asset sold into the trust. If this is the sole concern, then section 3(3)(d) of the Estate Duty Act provides ample ammunition for SARS to attack trusts being used to avoid Estate Duty. If section 3(3)(d) does not apply, then it is submitted that the deceased did not enjoy the benefit of the assets in the trust, and therefore no Estate Duty has been avoided (i.e. the trust property is correctly treated as outside the deceased's dutiable estate).

It does not seem reasonable to create double taxation (section 7C plus attribution) in order to discourage the use of trusts for Estate Duty purposes, when the transfer of assets is subject to CGT (and often Transfer Duty) and the loan remains subject to Estate Duty. As noted above, trusts are used for many legitimate purposes other than estate duty in any case.

It is suggest that the final Davis Tax Committee (DTC) report on Estate Duty be considered before this proposal is introduced, so that the issue can be resolved in a holistic way.

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Non-resident trusts

Section 31 (transfer pricing) already applies to loans between a non-resident trust and a resident beneficiary of that trust (or a resident relative of a beneficiary, which would typically include the founder), as they are connected persons. Consequently, such loans must be at arm's length, meaning market-related interest must be charged. Section 7C will compare the interest charged on such loans to the official rate, rather than to the arm's length rate. Typically, an arm's length rate would be higher than the official rate for foreign loans in any case, so section 7C would not find application. However, where it did apply there is nothing to prevent both section 7C and section 31 from applying to the same loan, which could lead to an adjustment under both provisions, and a deemed donation under both provisions. This is far too punitive. Failure to apply an arm's length rate of interest on a foreign loan should be dealt with exclusively in terms of section 31.

Solution

Loans to foreign trusts should be excluded from section 7C, and remain subject to section 31. Section 7C would consequently be a domestic transfer pricing rule for local trusts, as seems to be the intention.