The draft Taxation Laws Amendment Bill, 2016 (TLAB) was published on 8 July 2016 and contains an interesting proposed amendment to the tax laws governing the provision of an interest-free or low-interest loan by a taxpayer to a trust.

INTRODUCTION

Currently, taxpayers are able to sell an asset to a local or foreign trust on loan account or lend cash to the trust to enable it to acquire assets, and charge low or no interest on the loan without too many adverse tax implications. The creation of the loan account does not trigger donations tax of 20%, and the lender does not receive interest on which income tax is payable, although the attribution rules might apply such that the whole or a portion of the trust’s income or capital gains could be taxable in the lender’s hands. The loan granted to the trust remains an asset in the estate of the lender, but it does not increase in value for the lender because the growth in the asset acquired financed by the loan occurs in the trust, and the loan does not attract interest. The lender might reduce the loan each year by donating to the trust the maximum amount that can be donated without paying donations tax (R100 000), thus further minimising estate duty on the value of his or her estate.

The Budget Review document that accompanied Finance Minister Pravin Gordhan’s Budget Speech in February suggests that actions such as the above “create inequality” and indicated that people who set up and make use of trusts can expect amendments to the Income Tax Act and the Estate Duty Act that will seek to stop them from shifting assets into a trust in ways designed to avoid estate duty and donations tax.

THE PROPOSED AMENDMENTS

There are already anti-avoidance provisions mainly in section 7(5) and (8) of the Income Tax Act which apply to interest-free or low-interest loans to local and foreign trusts, with their counterparts in the Eighth Schedule dealing with capital gains. Essentially under these provisions, the value of the interest forgone on a loan to a trust is deemed to be a “donation” by the lender to the trust, and any income or gains generated by the trust that are attributable to that “donation” will be deemed to be earned by the lender and taxed in his or her hands personally. The interest that should have been charged under this provision is calculated at a market-related interest rate and is not prescribed by SARS. This deemed donation is not subject to donations tax.

Treasury is clearly of the view that the above anti-avoidance provisions are insufficient, hence the latest anti-avoidance amendments. The first proposed amendment under the TLAB is the insertion of an entirely new section 7C into the statute. Section 7C will provide that where a natural person or a company in relation to which that natural person is a connected person, directly or indirectly makes a loan to a trust of which that person (or any connected person) is a beneficiary, an amount equal to the difference between the interest that would arise as determined with reference to the official rate of interest for fringe benefits tax purposes, and the actual interest that should have been charged on the loan.

The proposed changes to interest-free loans to trusts are intended to prevent taxpayers from using trusts to artificially reduce their taxable income and to avoid estate duty and donations tax.
interest that is charged on the loan to the trust, will be regarded as an amount of income accrued to or received by the seller. Currently, on a loan designated in rand, the official rate is 8%. So if, for example, the loan is R10 million outstanding for a full year, interest free, the deemed income will be R800 000. This deeming provision relates only to the lender and not the borrower, so that trust will not be deemed to have incurred an interest expense of a like amount.

Such amount will not qualify for the interest exemption available to individuals under section 10(1)(i) of the Income Tax Act, which currently exempts interest received by a natural person up to R23 800 (below 65 years of age) or R34 500 (above 65 years of age).

Further, an amount equal to the difference between the amount of normal tax that would have been payable had interest at the official rate not been included in the taxable income, and the amount of normal tax payable by the taxpayer after the inclusion of the amount calculated at the official rate of interest, may be recovered from the trust. This right of recovery is given in the section, so that presumably the trust must oblige.

The provision goes further in that if the amount (the difference in the tax payable) is not recovered from the trust within three years, it must be treated as a donation to the trust and taxed as such. Thus, in the example above, the donations tax will be 20% of R800 000, i.e. R160 000. This may pose a problem with respect to offshore trusts, as the right of recovery granted to taxpayers under this section cannot be imposed in offshore jurisdictions. As such, trustees of foreign trusts may simply refuse to pay the lender the amount, in which case, the lender will be subject to donations tax.

Finally, the donations tax exemption under section 56(2) of the Income Tax Act, being the exemption of the first R100 000 donated, will not be applicable to any amount owing in respect of a loan that is disposed of under a donation.

The draft provision contains no reference to the existing sections 7(5) and 7(6) and their Eighth Schedule counterparts, and so it remains to be seen how these provisions will interact, most of all to ensure that a taxpayer is not taxed under both provisions.

CONCLUSION

An amendment is unsurprising given the statements made in the Budget Review document. However, the Davis Tax Committee specifically recommended that no attempt must be made to implement transfer pricing in the event of financial assistance or interest-free loans being advanced to trusts. That said, we see little point in an amendment of this nature. It appears to be a duplication of the law as it already exists, which could lead to a duplication of the tax charge, and it would serve everyone better if the existing provisions were tightened up with suitable amendments and enforced in a more standard manner, so that there was a standard set of rules that all could play by.
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