FAMILY TRUSTS AS INVESTMENT & WEALTH PRESERVATION VEHICLES AS PER THE DAVIS TAX COMMITTEE RECOMMENDATIONS

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LEGAL BRIEF
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The fiscus treats trusts as the black sheep of the family of investment vehicles available to South African tax residents. The contents of the interim report of the Davis Tax Committee **("DTC")** created the impression that the trend will be continued. These developments raised the question whether it is still viable for South Africans to structure their affairs through a family trust – both locally and/or overseas.

INTRODUCTION

In this article we explore the usefulness of a discretionary trust as an investment vehicle should the recommendations of the DTC be implemented. The conclusion is that, even if the recommendations of the DTC would be accepted and introduced into our tax laws, trusts would remain useful and popular investment vehicles for purposes of preserving wealth, and in particular significant wealth.

SOUTH AFRICAN TRUSTS

In respect of South African trusts, the above conclusion results from a comparison of investments in listed shares, fixed property and interest-bearing instruments made by a South African tax resident:

> natural person;

> family/discretionary trust with natural persons as beneficiaries;

> company with natural persons as shareholders; and

> company which is wholly-owned by a South African discretionary trust with natural persons as beneficiaries.

It is not intended to go into technical detail, but in order to give context to the comparisons made, a short summary of the tax principles relevant to the various investors is provided.

NATURAL PERSONS

Natural persons who are South African tax residents are taxed at a sliding scale with a maximum tax rate of 41% in respect of revenue profits and 13.653% on capital gains.

On death, they are deemed to dispose of their assets at market value on date of death for capital gains tax **(CGT)** purposes, so that any fictional gain arising attracts CGT at 13.653%. In addition, natural persons are liable to estate duty at 20% of the value of all assets forming part of their estate. The death taxes provide for certain rollover reliefs, such as relief in respect of assets acquired by a spouse of the deceased. The DTC recommends that inter-spousal relief measures be withdrawn or be subjected to a limit.

SOUTH AFRICAN TRUSTS

A trust (unlike a company) is not a legal person, but for tax purposes it is a separate "person", taxable at a flat rate of 41% on revenue profits and 27.306% on capital gains. In determining who should be taxed on income or capital gains accruing to a trust, the following three-step procedure must be followed:

> Firstly, consideration must be given to whether amounts derived by the trust are attributable to a donation, settlement or other disposition (e.g. the benefit enjoyed by a trust of not having to pay interest on a loan) made to it by a South African resident. If that is the case, so much of the amount which is attributable to the donation, settlement or other disposition must be disregarded in the trust and must be taxed in the hands of the person who made the donation, settlement or other disposition to the trust. These rules are referred to as the **"attribution charges".**

> To the extent that an amount which accrued to a trust is not attributed to another person under the attribution charges, consideration must be given to whether the amount is vested in a trust beneficiary during the same tax year. If it is so vested during the same tax year, the amount is taxed in the hands of the beneficiary to the exclusion of the trust. These rules are referred to as the **"beneficiary charges".**

> Finally, if neither the attribution charges nor the beneficiary charges apply, the trust is taxed on the accruals and a subsequent distribution to a beneficiary is not subject to any further tax.

The DTC recommends the repeal of the attribution and beneficiary charges in relation to South African trusts, so that all amounts accruing to a South African trust would be taxed in the trust at the trust's tax rate of either 41% or 27.306%.

COMPANIES

Companies are taxed at a flat rate of 28% on revenue profits and 18.648% on capital gains. Upon a distribution of a dividend to a natural person or a trust (regardless of whether the dividend is distributed from revenue profits or capital gains), the shareholder is subject to a 15% withholding tax **(WHT)** on dividends.

Assumptions for comparison

The comparison table below assumes the following:

> All natural persons (investors in their personal capacities, or shareholders of a company, or beneficiaries of a trust) are South African tax residents who are subject to South African tax at the maximum rates of 41% and 13.653% respectively

> The investment assets are held on capital account and not for speculative purposes

> Companies are funded by way of equity capital only

> Trusts are funded by way of loan funding – either interest-bearing or not

> Exemptions from, or rollover relief in respect of, the death taxes (e.g. spousal relief) are not available

	Individual	**Company**	**Discretionary Trust (current rules)**	**Discretionary Trust (DTC rules)**	**Company owned by a Discretionary Trust and DTC rules apply**
Dividends: listed shares	15% WHT	No WHT	15% WHT	15% WHT	No WHT
Rental: fixed property	41% tax	28% tax	41% tax	41% tax	28% tax
Interest: interest-bearing instruments	41% tax Rebate of R23 800/R34 500	28% tax	41% tax	41% tax	28% tax
Proceeds on disposal of assets (a premium on disposal of an interest-bearing instrument would likely be interest)	13.653% CGT Annual rebate of R30 000	18.648% CGT	27.306% CGT if retained 13.653% CGT if a natural person is taxed under the attribution or beneficiary charges	27.306% CGT	18.648% CGT
Distribution of after-tax investment returns or disposal proceeds	Not applicable	15% WHT	No WHT	No WHT	15% WHT
CGT on Death	CGT of 13.653% on fictional gain calculated on the difference between the market value, on death, of the assets and their base cost Rebate of R300 000 in year of death	CGT of 13.653% on fictional gain calculated on the difference between the market value, on death, of the shares in the company and their base cost Rebate of R300 000 in year of death	No tax on assets in trust. No gains on loans to trust.	No tax on assets in trust. No gains on loans to trust.	No tax on assets in company or the shares owned by the trust. No gains on loans to the trust.
Estate Duty	20% on the value of all assets on death. Rebate of R3.5 million or R7 million in aggregate for spouses. (DTC proposes R6 million rebate per person and no aggregation for spouses)	20% on the value of the shares in the company Rebate of R3.5 million or R7 million in aggregate for spouses. (DTC proposes R6 million rebate per person and no aggregation for spouses)	No tax on assets in trust. Estate duty only on the value of loans to trust – estate duty thus avoided on the growth in the assets.	No tax on assets in trust. Estate duty only on the value of loans to trust – estate duty thus avoided on the growth in the assets.	No tax on assets in the company or the company's shares owned by the trust. Estate duty only on the value of loans to the trust – estate duty thus avoided on the growth in the assets.

It is clear from the above comparisons that the main impact of the DTC's proposals would be that trust income and gains can no longer be diverted to natural persons who may be liable for tax at a lower rate (in the case of CGT at least half the rate applicable to trusts), either through a trigger of the attribution charges or the beneficiary charges.

As South Africans are liable to donations tax at 20% when they make donations to a trust, the attribution charges are seldom triggered as a result of a donation to the trust. More often, the attribution charges are triggered as a result of interest-free or low-interest loans being advanced to the trust so that the tax diverted to natural persons under the attribution charges is generally limited in that it only relates to the benefit arising for the trust from the favourable interest arrangements.

The "cost" of diverting the trust's tax to natural persons through the beneficiary charges is that the amounts vested in the natural person would form part of that person's estate for estate duty purposes.

Where the beneficiary is a non-resident, however, there could be harsher consequences of not allowing an amount to flow through. For example, a non-resident beneficiary would generally not be subject to South African tax on interest conduited to him through a South African trust. If the interest is in future taxed in the trust even if it is distributed during the same year to a non-resident, a tax-free amount will effectively attract 41% tax.

The avoidance of the death taxes (both estate duty and CGT) achieved by a trust structure would often outweigh the higher CGT rate upon actual disposals of assets by a trust structure, especially if the increased CGT rate is mitigated by holding the assets in an underlying company.

OFFSHORE TRUSTS

In terms of current tax laws, South African tax residents with offshore discretionary trust structures can be subject to South African tax in terms of similar attribution and beneficiary charges, and in particular on amounts:

> arising in a foreign entity as a result of a donation, settlement or other disposition in favour of the foreign entity, in terms of rules similar to the attribution charges described in relation to South African trusts above; and

> accrued to a foreign trust which are vested in a South African beneficiary during the same tax year (to the extent that the attribution charges do not apply) – the amount vested in the beneficiary retains its nature; or

> distributed by a non-resident trust out of amounts that accrued to the trust in a prior tax year and which were retained in the trust, if the amounts would have been subject to tax had the foreign trust been a resident – so if the amount of the distribution is funded from, say, interest retained in the trust the South African beneficiary will be liable to income tax on the distribution because the trust, had it been a resident, would have been subject to income tax on interest. Similarly, if the amount is distributed from a foreign dividend received from a foreign subsidiary of the trust in a prior tax year, the beneficiary will not be subject to tax on the distribution as the trust, had it been a South African tax resident, would have benefited from the participation exemption for foreign dividends on equity interests of 10% or more in foreign companies.

In addition, transfer pricing rules could result in taxable adjustments being made in respect of non-arm's length transactions entered into between South African residents and the foreign trust or foreign company, for example if a resident made an interest-free loan to the offshore trust, the resident will for tax purposes be deemed to have earned an arm's length interest on the loan.

The DTC recommends that the attribution rules in relation to foreign trusts be retained, but that the beneficiary charges be amended to subject to income tax all distributions from foreign trusts, irrespective of the funds out of which the distributions are made.

As foreign companies which are majority-owned by South African tax residents are controlled foreign companies, the income and gains of which are attributed to the South African shareholders, the South African tax implications of investing in foreign assets in a natural person's personal capacity or through a controlled foreign company, are similar. As such, we compare in the table below the South African tax position of an investment in foreign listed shares, foreign fixed property and foreign interest-bearing instruments made by:

> a South African tax resident natural person;

> a foreign discretionary trust with South African tax resident natural persons as beneficiaries; and

> a foreign company which is wholly owned by a foreign discretionary trust with South African tax resident natural persons as beneficiaries.

The comparison is based on the same assumptions applicable to the comparison in relation to South African assets, discussed above. In addition, for the sake of simplicity:

> any treaty relief which could apply is ignored;

> it is assumed that the attribution rules and transfer pricing rules will not apply – which would be the case if transactions (such as funding) between residents and the foreign entities are at arm's length terms.

	Individual	Discretionary Trust (current rules)	Discretionary Trust (DTC rules apply)	Company owned by a Discretionary Trust and DTC rules apply
Dividends: foreign listed shares	15% foreign dividends tax	No SA tax if retained 15% foreign dividends tax if distributed in the same tax year	No SA tax if retained 41% tax if distributed	No SA tax
Rental: foreign fixed property	41% tax	No SA tax if retained 41% tax if distributed in the same tax year	No SA tax if retained 41% tax if distributed	No SA tax
Interest: foreign interest-bearing instruments	41% tax	No SA tax if retained 41% tax if distributed in the same tax year	No SA tax if retained 41% tax if distributed	No SA tax
Proceeds on disposal of assets (a premium on disposal of an interest-bearing instrument would likely be interest)	13.653% CGT	No SA tax if retained 13.653% CGT if distributed in the same tax year	No SA tax if retained 41% tax if distributed	No SA tax
Distribution of after-tax investment returns or disposal proceeds	Not applicable	If distributed in the same tax year – see above If distributed in a subsequent tax year and from retained: • interest: 41% income tax • dividends on listed shares: 15% foreign dividends tax • rental: 41% income tax • proceeds on disposal of capital assets: 13.653% CGT • initial funds settled on the trust or dividends from foreign companies in which the trust holds 10% or more of the equity and voting rights: no tax	All distributions subject to 41% income tax	Distribution from the company to the trust: • No SA tax Distribution from the trust to the SA tax resident beneficiaries • 41% income tax (note that in terms of current rules, distributions from retained dividends from the underlying company can qualify for tax-free distribution to SA resident beneficiaries)
Funding to foreign trust or company at arm's length	Not applicable	Interest on loan to trust subject to 41% tax	Interest on loan to trust subject to 41% tax	Interest on loan to company or trust subject to 41% tax
CGT on Death	CGT of 13.653% on fictional gain calculated on the difference between the market value, on death, of the assets and their base cost. Rebate of R300 000 in year of death	No tax on assets in trust. No gains on loans to trust.	No tax on assets in trust. No gains on loans to trust.	No tax on assets in company or the shares owned by the trust. No gains on loans to the trust.
Estate Duty	20% on the value of all assets on death. Rebate of R3.5 million or R7 million in aggregate for spouses. (DTC proposes R6 million rebate per person and no aggregation for spouses)	No tax on assets in trust. Estate duty only on the value of loans to trust – estate duty thus avoided on the growth in the assets.	No tax on assets in trust. Estate duty only on the value of loans to trust – estate duty thus avoided on the growth in the assets.	No tax on assets in the company or the company's shares owned by the trust. Estate duty only on the value of loans to the trust – estate duty thus avoided on the growth in the assets.

The above comparison indicates that the DTC recommendations negatively impact the South African tax implications of actual distributions of wealth from the structure, but importantly they do not extend their tentacles into wealth preserved and grown within the structure or to wealth passed on to next generations through the structure.

CONCLUSION

The DTC report is an interim report and even if the recommendations are retained in the final report, it should be noted that often the recommendations of tax committees do not find their way into the tax legislation. At this stage, though, even if it has to be assumed that the DTC recommendations will find their way into our law, the case for the continued viability of trusts as wealth preservation and investment vehicles for South African tax residents remains strong.

The bigger the wealth retained within a structure compared to the withdrawals by beneficiaries during their lifetime, the stronger the case in favour of a trust structure – both locally and abroad.

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Doelie Lessing is a specialist in corporate tax matters with specific emphasis on the tax issues associated with mergers and reorganisations of corporate entities; private equity deal structuring and black economic empowerment transactions. Her expertise extends to tax planning for international corporates, executives and wealthy families, tax structuring for local and international investment funds, Africa-specific investments and employee incentive plans. She has also undertaken tax-related litigation, alternative dispute resolution and settlements for a variety of clients.

Doelie is named amongst the world's leading private client lawyers in *Who's Who Legal: Private Client 2014* and *Who's Who Legal 2015 – Compendium Edition*. She is also named as a highly-regarded practitioner in the International Who's Who of Corporate Tax Lawyers (2013), where the publication states she is known for "delivering high-end work in a timely manner".

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Doelie is also a member of the International Tax Planning Association. She is the co-founder and past chairman of the Society of Trust and Estate Practitioners (STEP), Cape Town and acts as external examiner for the Tax Masters course offered by the University of Cape Town. Doelie is also the co-author of the South Africa chapter of the Practical Law Private Client Multi-jurisdictional Guide, 2014 edition.

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Yvonne Steyn joined Werksmans Attorneys as a candidate attorney in 2011 and in 2013 became an associate in the commercial law department of the firm. Her areas of speciality include general commercial law with an emphasis on company law. She also advises on insolvency and business restructuring.

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Established in the early 1900s, Werksmans Attorneys is a leading South African corporate and commercial law firm serving multinationals, listed companies, financial institutions, entrepreneurs and government.

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With a formidable track record in mergers and acquisitions, banking and finance, and commercial litigation and dispute resolution, Werksmans is distinguished by the people, clients and work that it attracts and retains.

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