TIGHTENING UP ON THE OFFSHORE TRUST RULES

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LEGAL BRIEF
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The general principle is that South African resident individuals who have settled offshore trusts are taxed on the income and capital gains of that trust (or its underlying subsidiary) in terms of the Income Tax Act, 1962 (the Act).

This rule applies not only where there is an out-and-out donation to the trust, but also where interest-free loans have been made to the trust (or the underlying subsidiary). In such a case, the income and capital gains of the offshore structure are attributed to, and taxed in the hands of, the lender, in an amount equal to what the structure has "lost" because no interest at a market-related rate was paid on the loan.

Where these attribution rules do not apply, or have ceased to apply, no-one in South Africa is taxable unless and until a distribution is made by the trust. Where such a distribution is made, by and large the beneficiary in South Africa will be taxed on that distribution having regard to the nature of the income out of which it was distributed, for example, if it is a foreign dividend the beneficiary will be taxed at the effective rate of 20%; if it is interest he or she will be taxed at 45%; and if it is a capital profit it could be taxed at 18% (all assuming the maximum marginal rate of tax applies).

DISTRIBUTIONS OUT OF CAPITAL

Of course, if no resident is taxable on the income of the offshore structure under the attribution rules, and no distribution is made by the trust out of current year's income to a South African-resident beneficiary, then no tax in South Africa is payable.

If the income of the trust was then added to the capital of the trust and an award was made out of that capital in a subsequent year, there could have been an argument that the amount receivable by the beneficiary in South Africa was not subject to tax. For this reason, there is a provision in the law that says that such a distribution out of capital will be taxed as income or as a capital gain, depending upon how that capital arose.

EXCEPTIONS TO THESE RULES

There is in the Act an exemption from tax on foreign dividends, where a person holds at least 10% of the equity shares and voting rights in a foreign company (a qualifying interest). Any dividend is therefore completely exempt from tax, instead of being taxable at the effective rate of 20%.

This exemption, colloquially known as the participation exemption, also applies to disposals of shares under prescribed circumstances, also where the shareholder holds a qualifying interest. In such a case, the disposal is exempt from CGT.

Bearing in mind these participation exemptions, the rules described above incorporated those exemptions as follows:

> Where the attribution rules apply, if the current year's income of the trust comprised a dividend from a foreign company, where the trust held a qualifying interest, that dividend is not taxable in the hands of the donor or of the lender under the interest-free loan; and neither is it taxable as a capital gain if the trust had disposed of the shares in the prescribed circumstances.

> Similarly, where such a dividend or gain has been capitalised, and in a future year that capital was awarded to a beneficiary in South Africa, that award would be exempt from tax on the dividends or CGT, as the case may be. (Ironically, if the trust had earned the dividend in the current year and had awarded it to a beneficiary in the current year, that beneficiary would have been taxable at the rate of 20%, while a capital profit made and awarded in the same year is not taxable. As one well knows, the Act is not always consistent or rational.)

THE PROPOSED NEW RULES

On approximately three occasions in the past, Treasury and SARS have attempted to counter possible tax avoidance, where offshore companies are held under offshore trusts, thereby by-passing the controlled foreign company (CFC) rules, in terms of which profits of CFCs are effectively taxed in the hands of the South African shareholders (subject to certain exemptions).

The first two attempts were abandoned, and the third attempt, last year, was partially implemented, but applies only in very limited circumstances. It was stated that, for more general application, the matter would be held over until 2018.

Treasury and SARS have now decided to abandon the attempt to bring offshore companies held by offshore trusts into the CFC rules. As an alternative, however, the draft legislation now out for public comment incorporates amendments to the attribution and distribution rules. In brief, these are as follows:

> Where a trust receives a dividend from a foreign company in which it holds a qualifying interest, the current year's dividend will be attributed to the donor to the trust or the lender of the interest-free loan.

> If these attribution rules do not apply, or have ceased applying, and a trust receives a dividend where it holds a qualifying interest, and the dividend is capitalised, any award out of capital in the future year to a beneficiary in South Africa will be taxable at the effective rate of 20%.

> The new rules will apply similarly to CGT, so that what would normally have escaped tax under the attribution rule or out of an award of capital in the current or a future year, will in future be subject to CGT.

There are certain difficulties and anomalies with the draft legislation, in respect of which Werksmans (among others) have made representations. It remains to be seen how successful these will be.

In order not to be retrospective, the new rules are supposed to apply to any dividend received or disposal of shares on or after 1 March 2019. If this is indeed how the final legislation reads, it will mean that any dividend on a qualifying interest, or any profit on disposal of a qualifying interest, derived by the offshore trust by no later than 28 February 2019, and capitalised, will still be able to be awarded out of capital in a following year exempt from tax.

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