Taxation of Trusts

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Draft Taxation Law Amendment Bill published earlier this month

We have been on the lookout for further comment and proposed legislation from Treasury for a while now, particularly with the statements made by the Minister of Finance in the Budget Speech in February 2016 regarding trust loan accounts. This has now arrived in the form of the draft Taxation Law Amendment Bill earlier last month. The explanatory note from National Treasury heads the relevant sections as: *Introducing Measures to Prevent Estate Duty and Donations Tax Avoidance Through the Transfer of Assets to a Trust Using Interest Free Loans.*

Bill seeks to inhibit the use of interest free loans to fund or capitalise trusts

In essence, this is a strike against the entrenched Estate Planning technique of using interest free loans to fund or capitalise trusts. In the past this structuring allowed the value of any assets transferred to a trust to be frozen in the planner's estate, with the growth shielded from estate duty and without any immediate or ongoing tax consequences (i.e. donations tax or tax on interest). This, together with the nature of trust taxation[1], usually meant that, at worst, the trust would be tax neutral for income tax purposes with all the estate planning, succession and protective benefits of the trust at the forefront. In addition, the wording of the Bill is such that it is also likely to reduce the ability of trustees to distribute income and gains to underlying beneficiaries of the trusts without any physical payment (i.e. allocated on loan or current account). In the future, there will be ongoing tax and cash flow costs associated with these funding and loan arrangements, if this legislation is enacted.

Proposed legislation includes 'deeming provision'

From a technical standpoint the proposed amendment to the Income Tax Act is the insertion of another "deeming provision" in Section 7 (a new S7C). The proposal includes the following aspects:

- Interest will be deemed on any interest free (or low interest) loans made to a trust by any *connected person*[2] (or a company that is a connected to that person).
- The definition of a loan is fairly wide as the provisions include …*any loan, advance or credit*…
- The difference between the official rate and the actual rate paid is the deemed interest to be included by the person making the loan. Currently the applicable rate is 8% p.a. for local transactions.
- The deemed interest attributed will <u>not</u> qualify for the normal annual interest exemption for the planner.

[1] Through the *conduit pipe* principle and the *attribution rules*.

[2] Applies if a person or relative is a beneficiary of the trust.

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- The trust will not be able to deduct this imputed interest attributed against its own taxable income.
- No reduction of the loan account by the annual donations exemption amount of R100,000 will be allowed.
- The income tax that is attributable to this imputed interest income will be treated as a donation should the individual not reclaim the tax from the trust within a three year period.

The proposed effective date of implementation is 1 March 2017 (i.e. applicable for years of assessment ending after this date). Some commentators question whether these provisions are applicable to transactions after this date only and not to existing arrangements prior to this date. However, a more prudent approach would be to read it more widely and take it that it applies to loans that are in existence from this date onwards.

An Illustrative Example
To put these proposals in context we use the following example. A local share portfolio worth R5 million is transferred to The Great Expectations Trust by Miss Havisham. The funds are effectively loaned by her on an interest free basis and she is a beneficiary of the trust. If the legislation goes through, then Miss H would have interest of R400,000 imputed in her tax return at the end of February 2018. She would not be able to use her interest exemption of R23,800 (R34,500 if over 65) against this income. If her marginal rate of tax is 41% then this would result in tax of R164,000 being due. If she does not claim this tax within a three year period then there would also then be donations tax applied at 20% - i.e. tax of R32,800. The trust would not be able to write this imputed interest off against its taxable income as an expense in the production of income[3].

If the trust were to make a capital gain from sales of say R100,000 the trustees often elect to distribute the gain to a beneficiary (say Estella) to avoid the higher rate of tax in the trust. If this is allocated rather than paid (to get the estate duty advantage) then this could be construed as a loan to the trust by the beneficiary. Interest could then be imputed and interest of R8,000 included in the tax return of the beneficiary concerned.

Current environment
It is of interest that the recommendations of the Davis Tax Committee (DTC) in their initial report on Estate Duty in 2015 appear to have been ignored. Furthermore, this proposed amendment is divergent from the recommendation that the DTC proposed with respect to loan accounts. Any follow up report from the DTC has failed to see the light of day yet. Effectively the question is whether the expansive tampering proposed by the DTC to the taxation regime for trusts will come through and to what extent it will be applied. Is this the first salvo as it were or the only adjustment for the foreseeable future? There is therefore some policy uncertainty for planners and advisers.

It is important to recognise that as it stands, this Bill only has implications for loans made or credit advanced to trusts. Thus, the other aspects and benefits associated with trusts continue to apply. These include the following:

- The *conduit pipe* principle – where the beneficiaries are taxed on income and gains of the trust to the extent that the income and gains are distributed during the year of assessment to those beneficiaries.
- Testamentary trust provisions.
- Older trusts where loans have been extinguished.
- Estate planning broadly.
- Protection – beneficiaries, creditors and the like.

[3] Note: as trust's income is likely to mostly be dividends from shares this would not be of any benefit in this example anyway.

- Succession planning and preservation of family wealth.

Proposed Provisions still in the form of a Bill
We would emphasize that these proposed provisions are still in the form of a Bill and open for public comment. It is possible that the provisions are amended or changed entirely through iterations of the Bill before passing through Parliament and becoming part of the Income Tax Act. There is also still time to review matters before the provisions become applicable based on the current proposed implementation date.

Suggested action
It is thus advisable to avoid drastic action in the absence of legislative certainty. However, it would be prudent to consider the following aspects now to be in a position to act:

- Ensure that the Trust financial statements are finalised as soon as possible for the Feb 2016 tax year. This will provide details of the current funding structure inherent in the trust and any potential costs that may arise.
- Consider how existing loan accounts could be dealt with and contemplate action within the financials for Feb 2016 (if possible) and/or for the year ended Feb 2017.
- Contemplate renegotiating the terms of any loans that will continue into March 2017 (adding interest to the terms of the agreement?)
- Assess the nature of trust assets and consider the overall Estate Planning objectives related to the trust – i.e. protective elements, estate planning as well as the likely additional costs of running the trusts from an income tax perspective.

In many ways we are still adopting a 'wait and see' approach but as we now have some concrete proposals, we should be armed with the facts associated with our own situation. Using a Rio Olympics analogy, we would argue that the starter has now called "get set". We should gather ourselves to be quickly out of the blocks but also ensure we avoid a false start.

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