PERSONAL
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Income Tax Legislative Update

President Jacob Zuma has now signed off on several finance and taxation related Bills which were passed by Parliament late last year. Foremost in the minds of many are the following aspects related to individuals:

1. <u>Taxation of Loans made to Trusts (new Section 7C)</u>

This provision in the Taxation Laws Amendment Bill reduces the ability to avoid estate duty and donations tax through the use of interest free (or low interest) loans. In effect, the old ploy of “freezing” the value of a planner’s estate by transferring growth assets out of their hands to a trust by way of an interest free loan has come under attack. There will now be an ongoing tax cost arising for the planner. This new provision will apply to new and existing loans made to a trust as of 1 March 2017.

The mechanism by which Revenue wishes to introduce a tax cost to these planning arrangements is to deem a market related interest rate (the official rate used and published by SARS) on a loan made to a trust. This is either by applying the official rate of interest to the loan (if it is interest free) or the difference between the rate actually charged and the official rate.

It is important to note that the loan captures any “… loan, advance or credit” made or arising between a natural person and a trust, whether directly or indirectly. It applies to loans made by individuals or a company at the instruction of the planner, where there is a “connected persons” relationship.

The gist of the legislation has remained the same through various iterations of the Bill, namely to deem a rate of interest on affected loans. What has changed is how the deemed interest is to be taxed in the hands of the person who made the loan. The final draft deems the act of not charging interest (or undercharging interest) to be a donation for Donations Tax purposes. This is effectively a watering down of the previous wording of the Bill where the deeming of interest was to be dealt with as income for income tax purposes (along with other restrictive aspects).

An example of the application would be as follows: Mr Bennet loans R5 million to The Longbourne Estate Trust, where his five daughters are the beneficiaries, with no interest being charged on the loan. With the official rate being 8% p.a. at present, the effective deemed interest would be R400,000 for the year. If we assume that Mr Bennet made no other donations during the year then his exempt portion of R100,000 would apply. So the tax cost to Mr Bennet would be R60,000 in the first year (R300,000 taxable donation at the 20% donations tax rate).

At current interest rates a loan outstanding to a trust of R1.25 million is the equivalent of the tax free donation’s annual exemption of R100,000. Any loan below this value would avoid any tax cost but one would then obviously not be able to reduce the value of the loan account by donating the R100,000.

Of importance are various exclusions to these provisions. The following loans, advances or credit extended will fall outside of the provisions:

- Public Benefit Organisations
- Funding of a primary residence (wholly or partly) used by the person or their spouse
- Certain situations where there is a vested interest in the trust[i]. This may include accumulated capital arising from income and gains distributed to beneficiaries but retained in the Trust. (See explanatory note i)
- Trusts created for disabled persons
- Where the provisions of Section 31 ("Transfer Pricing") apply – i.e. this should exclude loans to foreign non-South African resident trusts
- Loans compliant with Sharia Law
- Where dividends tax applies to the loan – S64E(4)

The benefit of the growth in the assets accruing to the trust still remains under current legislation, so there may still be a tax advantage at the end (net of any tax and costs) depending on the nature of the assets and the growth. However, this estate duty saving is a future benefit that accrues to the heirs and beneficiaries of the planner, while the donation tax cost is current and ongoing and is payable during the existence of the loan during the planner's lifetime. There is a cash flow timing difference which may not be palatable to all.

As mentioned in previous communiqués there is also the issue of the Davis Tax Committee (DTC) and their report. It appears to us that Treasury has applied their own "independent" anti-avoidance provision which is not really in line with the recommendations of the DTC. It thus remains uncertain whether the application of S7C should be seen as the singular anti-avoidance legislative intervention or whether there will be additional measures introduced in time. Of particular importance is the matter of the "conduit principle" applicable to the taxation of trust income and capital gains, as well as estate duty abatements and the like. Having a sense of the regulator's approach will help provide a more certain planning environment to operate in. The next Budget Speech will be closely watched for any additional regulations impacting on estate planning.

The free parking card which has existed for many years in estate planning has come to an end but that does not mean that trusts are to be consigned to the planning scrapheap. It does depend on the specifics of each situation and each case needs to be considered on its merits, whether looking at existing structures or when having new planning deliberations. Clearly the size and nature of loan accounts is of critical importance so Annual Financial Statements and loan values need to be brought up to date.

Your Trust Officer at Personal Trust will be able to assist with these deliberations.

2. <u>Additional Voluntary Disclosure Programme</u>

In terms of the new Bills an Additional Voluntary Disclosure Programme (AVDP) has now been approved. This allows non-compliant taxpayers with undisclosed offshore assets to make a voluntary disclosure and regularise their affairs and offshore assets. The Common Reporting Standard (CRS) is the global standard for the automatic exchange of financial account information between over 90 countries' tax authorities. The CRS comes into effect from September 2017 for South Africa and is reported on annually. This means that there is little room to hide from the tax authorities around the world.

The main points with respect to the AVDP are:

- The window period has been extended until 31 August 2017. Applications for relief have theoretically been open from 1 October 2016 even though this was prior to the legislation being approved.
- The new AVDP falls within the ambit of the current existing Voluntary Disclosure Programme (VDP)[ii].

- Individuals and companies may apply and can do so on a "non-name approach" in a representative capacity.
- Trusts do not qualify but settlors/donors, deceased estates and beneficiaries of offshore discretionary trusts may apply. However, the offshore assets and income of the trust need to be deemed to be theirs for tax purposes.
- Anyone under audit or aware of a pending audit will not qualify.
- Any information obtained under the terms of any governmental exchange of information procedure is not eligible.

The terms applied to an application are as follows:

- 40% of the highest value of the aggregate of all assets situated outside South Africa between 1 March 2010 and 28 February 2015 that were derived from undeclared income will be included in taxable income. This is the market value determined in foreign currency converted to Rand at the spot rate at the end of each year of assessment.
- The undeclared income giving rise to the foreign undeclared assets is exempt from past income tax, donations tax and estate duty. Clearly future income, donations tax and estate duty will need to be taken into account.
- No criminal prosecution will be pursued against successful applications (as is the case for the current VDP).

In terms of the AVDP there is a concurrent ability to make disclosure to the Exchange Control Authorities to regularise offshore assets for Exchange Control purposes. Penalties of between 5% and 12% of the market value at 29 February 2016 are payable, depending on whether the penalty is funded from local or offshore assets.

Although there has been a reduction in the amount to be included in taxable income from 50% to 40% it still remains a stiff penalty, particularly when there may also be an Exchange Control penalty levied too. In some cases it may well be better to apply under the permanent VDP than the AVDP, even though SARS may be able to go back all the way to the original date of non-compliance under the former. The latter programme has a specific period – i.e. 1 March 2010 to 28 February 2015. The merits of each case would need to be weighed up.

With full disclosure of the beneficial owners of financial accounts internationally coming into effect it is likely that SARS will become aware of undisclosed offshore assets and the income that gave rise to them. The disclosure programmes offer the opportunity for individuals to clean up their affairs before SARS comes knocking first.

3. <u>Local Pensions and Foreign Service</u>

There is a provision in the Act[iii] that exempts the period of any foreign employment outside of South Africa from taxation on benefits paid from a South African pension fund. This relief has now been removed from the Act and its effective date is 1 March 2017.

As an example: Ms Emma Woodhouse worked overseas in the UK for 50% of the time she was employed by a South African company. She receives a monthly pension of R20,000. 50% of her pension would have been exempt from South African tax – i.e. R10,000 taxed in the normal way. Under the new rules the full R20,000 will now be taxable. This could clearly have a negative cash flow consequence for clients.

Note that the exemption remains intact but only for payments arising from foreign retirement funds or retirement capital transferred from a foreign fund to a local fund.

Notes

[i] The Explanatory Memorandum and Final Response Document's wording has created some comment about the situation where capital and income has been vested in the hands of beneficiaries but retained in the trust. . Some have read this to mean that outstanding amounts not yet distributed would not fall foul of the new provisions if certain terms exist in the trust deed related to the trustees' control of these "loans". This is not clear to us from the actual wording of the legislation.

[ii] The VDP is administered under the Tax Administration Act, 2011 with effect from 1 October 2012

[iii] Section 10(1)(gC)(ii)

Lorraine White, Director – February 2017