Business Accounting Network

BAN BULLETIN

June 2017

Going Beyond Accounting, Taking Business Forward

TRUSTS! Do They Have a Future? The New Tax Laws Evaluated

By Monique Sharland

If you have an inter-vivos trust, no doubt your intention of forming one was to sell your assets to the trust to circumvent estate duty (tax) upon your death and of course, to protect your assets. This has been a popular means to allow your assets to increase in value outside your estate.

For example, you might have "sold" your holiday house or listed share portfolio to a trust but, very likely, instead of the trust itself physically paying you for those assets, you funded it by way of an interest-free or low interest loan to the trust. As your loan to the trust is an asset for estate duty purposes, your accountant would have used skilful tax planning and written off your loan over time by using the R100 000 annual donations tax exemption to minimise estate duty.

New Tax Law: Section 7C of the Income Tax Act as it Applies to Interest-free and Low Interest Loans

SARS was of the view that this situation deprives the fiscus of estate duty.

As a result, new regulation by way of Section 7C of the Income Tax act came into effect on the 1st March 2017 and applies to any loan advance or credit (existing or new) made to a trust by:

- A natural person, or
- Any company, at the instance of that person in relation to which that person is a connected person (i.e. any person who individually or jointly with any connected person in relation to him/herself holds directly or indirectly at least 20% of the company's equity share capital or voting rights).

This new law requires that donations tax, (currently 20%), is payable on the difference between interest that would have incurred had the official rate of interest (currently 8%) been charged and:

- No interest levied on the loan to the trust, or
- The difference between low interest rate levied on the loan to the trust and the official interest rate

What is the Official Rate of Interest?

The official rate of interest is defined under paragraph 1 of the Seventh Schedule of the Income Tax act which links the repurchase (repro) rate to the official interest rate by adding 100 basis points thereon. The repro rate has been at 7% since 18 March 2016, causing the official interest rate to be at the current 8%.

Should You Be Charging Interest on Your Loan to Your Trust?

By way of a simple example, the tax liability of a loan to a trust can be illustrated as follows:

Example 1:
A trust acquired a family holiday property a few years ago for R 3 million which was funded by the lender, also a trustee, for the full amount by way of an interest free loan. The holiday house is used exclusively for family use and earns no income and therefore no expenses can be deducted, resulting in the credit loan account balance at 1 March 2017 remaining as the original loan amount, being R3 million.

Value of loan:
R 3 000 000

Interest:
R 240 000 (R 3 000 000 x 8% - 0%)

Deemed Donation:
R 240 000 less R100 000 annual donations tax exemption
= R 140 000 deemed donation by the lender

Donations Tax:
R 28 000 (R 140 000 x 20%) due and payable by the lender on 28 February 2018

The amount of R 240 000 is deemed to be a donation by the lender to the trust and not interest, and is taxed in the hands of the lender.

This deemed donation will be levied each year until the loan is repaid. The lender will be taxed each year as long as the loan exits.

Loans below R 1 250 000 will not give rise to donations tax (R 1 250 000 x 8% = R 100 000 less R100 000 annual donation exemption = 0).

Example 2:
A portfolio of listed shares and unit trust investments are owned by a trust and originally funded on loan account by the trustee to the value of R 3 million. The loan account was whittled down to R 2 million at February 2017 by use of the R100 000 donations tax exemption each year. Interest at 4% is charged on the loan for the year ending 28 February 2018.

Value of loan:
R 2 000 000

Interest:
R 80 000 (R 2 000 000 x 8% - 4%)

Deemed Donation:
R 80 000 less R100 000 annual donations tax exemption
= R 0 deemed donation by the lender

Donations Tax:
R 0

Donation balance to apply to remainder of loan:
R 20 000 (R 100 000 – R 80 000)

In this situation, no donations tax is payable by the lender as the R 100 000 exemption exceeds the deemed donation amount. The lender will not be entitled to the interest exemption for individuals (currently R 23 800). In addition, the balance of the annual exempt donation not used of R20 000 can be used to decrease the loan value by donating to the trust capital.

Importance of Vesting Clauses in Trust Deeds

An amount vested by a trust in a trust beneficiary that is not distributed or paid to that beneficiary will qualify as a loan by that beneficiary to the trust if that non-distribution results from an election exercised by the beneficiary that the amount not be distributed or paid over.
An amount that is vested irrevocably by a trustee in a trust beneficiary without distributing or paying it will not qualify as a loan or credit if the trustee has the sole discretion in terms of the trust deed to extend any distribution amount.

What Are the Exclusions to Section 7C?

- Primary residence: It will not apply to loans which are wholly or partly funded for the acquisition of a primary residence that is used throughout the year of assessment by the lender or their spouse.

- Special trusts created solely for the benefit of minors with disabilities.
- Loans made by a trust beneficiary of a vesting trust provided that certain qualifying provisions are met (rationale being that the vested interest of the beneficiary in the assets and receipts or accruals of such trust will form part of that beneficiary's estate – which is the aim of the provisions of s7C).
- Trusts that are approved public benefit organisations or qualifying small business funding entity;
- Affected transactions dealt with by section 31 of the Act (transfer pricing);
- Qualifying sharia compliant financing arrangements;
- Loans subject to the provisions of section 64E of the Act (to value extracting provisions).

Consequences of Section 7C

Section 7C will apply to all loans with effect from 1 March 2017 whether such loans were advanced before or after that date. The most significant consequence is the instances where the trust or lender does not have the money to settle this new tax obligation annually. It will therefore become penalizing if the trustees are forced to dispose of the assets to deal with this new tax liability.

Are There Solutions?

In some instances where the trust structure is not complex, it might be advantageous to move the assets out of the trust to a company that is 100% owned by the trust.

But the Income Tax Act rules as well as the Companies Act rules dealing with such a section 42 arrangement are complex, expensive and have unintended consequences such as having to apply for a new mortgage bond if property were to be transferred. A proper restructure of the trust's assets afforded in Section 42's asset for share transactions is tax efficient as it does not attract capital gains tax. Income producing assets in a company are in a much more tax efficient structure than a trust.

Is There a Future for Trusts?

Although trusts might become less popular for estate planning purposes, and despite the changing tax outlook, there is still a need for trusts. There are many other valid reasons for the use of trusts which may well outweigh any negative tax consequences. For example, they are still the ideal structure to hold high growth assets for estate planning purposes. For most professional people and business owners, trusts are also necessary for creditor and family asset protection.

Careful consideration should be given before new trusts are created and existing trusts should be carefully examined as soon as possible to ensure their continued effectiveness from a tax point of view.

We suggest that our clients obtain professional and specific advice from their BAN accountant. For more complex trust re-structuring, we may refer you to our specialist alliance partners, as each person's situation is different.

Monique Sharland
CEO of Business Accounting Network,
Monique is a professional accountant,
small business tax law expert and
and franchising specialist

CONTACT DETAILS

National:
0861 BAN BAN
(0861 226 226)

Fax:
086 719 8307

Postal:
PO Box 30101, TOKAI, 7966
Cape Town, South Africa

Email:
info@ban.co.za

Website:
www.ban.co.za