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TAX ALERT

IN THIS ISSUE

TAXATION OF TRUSTS IN THE FUTURE

Earlier this year the Davis Tax Committee (DTC) released its first report on estate duty for public comment. The report contained a number of disconcerting recommendations with regard to the taxation of trusts.

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TAXATION OF TRUSTS IN THE FUTURE

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Earlier this year the Davis Tax Committee (DTC) released its first report on estate duty for public comment. The report contained a number of disconcerting recommendations with regard to the taxation of trusts.

The DTC was tasked with considering the use of trusts as vehicles employed by taxpayers to divest themselves of their assets during their lifetime, thereby saving estate duty upon their death.

On the DTC's analysis, there are two main problems with the current regime relating to the taxation of trusts.

Firstly, the attribution rules contained in s7 of the Income Tax Act, No 58 of 1962, which are essentially anti-avoidance provisions for the prevention of income splitting, no longer serve their intended purposes. Where a donor divests themselves of income generating assets by transferring it to a trust, and s7 of the Act applies to attribute such income back to the donor, the donor could actually pay less tax on such income than if that income had been taxed in the hands of the trust. This is because a natural person donor would pay income tax at a rate between 0% and 41%, whereas a trust is always taxed at the flat rate of 41%.

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Secondly, the flow-through principle contained in s25B of the Act and paragraph 80 of the Eighth Schedule to the Act, allows the trust to escape the 41% flat rate (and 66,6% inclusion rate for capital gains) by distributing income and capital gains to natural person beneficiaries, who will be taxed at between 0% and 41% (and 33,3% inclusion rate for capital gains). Assets can also still remain in the trust, thereby falling outside the estate duty net.

Usually, when implementing a trust structure, natural persons would sell or otherwise transfer their assets to the trust, and leave the consideration outstanding on an interest-free loan account. Over time, the trust can repay the loan. Where the natural person consumes the amounts repaid during their lifetime, their estate would have been diminished at the time of death. In this manner the person avoids both donations tax and estate duty.

In this regard, the DTC has made the following recommendations:

- Trusts should remain taxable as separate taxpayers;
- Trusts should remain taxed at a flat rate; and
- The attribution rules and flow-through principle should be scrapped insofar as resident trusts are concerned.

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TAXATION OF TRUSTS IN THE FUTURE

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The DTC recommended that separate criminal sanctions should be imposed against taxpayers who fail to disclose their interests in foreign trusts.

However, the DTC did recommend that:

- An exception should be made for special trusts; and
- No transfer-pricing rule should be introduced in order to deter interest-free loans and other financial assistance to trusts.

In respect of foreign trusts, the DTC recommended that all distributions from foreign trusts should simply be treated as income. In addition, the DTC recommended that separate criminal sanctions should be imposed against taxpayers who fail to disclose their interests in foreign trusts.

The DTC's view seems to be that, instead of introducing new tax types such as capital transfer tax or net wealth tax, amending the current income tax regime for trusts as set out above, should be a sufficient deterrent to estate planning, and increase estate duty collections.

The DTC noted that it anticipates a call from taxpayers to be allowed time to dissolve their current trust structures before the recommendations are implemented, but the DTC is strictly opposed to such a window period because trusts must be dissolved in terms of their trust deeds, and it would be unfair to allow trusts to 'bank' their estate duty savings.

The DTC was hopeful that an extensive consultation process could be completed during 2015, and that its recommendations could be implemented by 1 March 2016. However, this goal now seems out of reach.

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