DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

DIVIDENDS TAX AND TRUSTS

General

Traditionally, two types of trust are recognised in our law, namely the *bewind* trust and the ownership trust. In the case of a *bewind* trust, the founder transfers ownership of the trust assets to the beneficiary, while the trustee is responsible for the administration of the trust assets. In the case of an ownership trust, the founder transfers ownership of the trust assets to the trustee and the rights of the beneficiary in respect of the trust assets are usually determined by the trust deed.

Two subcategories of the ownership trust are recognised. Where the trustee may from time to time exercise his discretion in order to vest the trust assets (income or capital) in the beneficiary, the trust is referred to as a discretionary trust. Where the rights in respect of the trust assets automatically vest in the beneficiary (without the trustee having to exercise a discretion), the trust is referred to as a vesting trust.

Where shares are held by a trust and a dividend is paid in respect of those shares, Dividends Tax will usually be triggered in terms of s64E(1) of the Income Tax Act No 58 of 1962 (Act). Section 64EA(a) of the Act places the liability for Dividends Tax on the "beneficial owner" of the dividend (in the case of a cash dividend). Also, depending on who the beneficial owner is, the dividend may be exempt from Dividends Tax in terms of s64F of the Act. For example, where the beneficial owner is a resident company, the dividend will be exempt.

The crucial question then in this regard is: who is the beneficial owner of the dividend? Is it the beneficiary, the trustee, or the trust?

The term "beneficial owner" is defined in s64D of the Act as "the person entitled to the benefit of the dividend attaching to the share."

Bewind Trust

In the case of a *bewind* trust, the beneficiary is the actual owner of the trust assets (eg shares). It would therefore make sense to also treat the beneficiary as the "beneficial owner" of the dividend (income) paid in respect of shares held by the trust, assuming of course that the beneficiary is entitled to the benefit of the dividend.

Discretionary Trust

However, in the case of a discretionary trust the situation is somewhat more complicated. In this case the trustee is the actual owner of the trust assets, but it would be difficult to argue that the trustee is entitled to the trust assets because the function of a trustee is to hold the trust assets for the benefit of the beneficiary. Because one is dealing with a discretionary trust, the trust assets (income or capital) only vest in the beneficiary once the trustee has exercised his discretion to that effect. Until such time, the beneficiary is not entitled to the trust assets and has only a contingent right, or hope, to them.

The only other option would then be to see the trust as the beneficial owner of the trust assets for the purposes of Dividends Tax. Even though a trust does not constitute a legal entity, it is considered a "person" for purposes of the Act and can be subject to tax.

This can lead to double taxation in certain circumstances.

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For example, a discretionary trust holds certain shares. The beneficiary of the trust is a resident company. A dividend is paid to the trust in respect of the shares. The trustee has not yet exercised his discretion and the trust assets (income or capital) have not yet vested in the beneficiary. The trust is seen as the beneficial owner of the dividend and is liable for Dividends Tax. Because the resident company beneficiary is not the beneficial owner, the exemption for resident companies in respect of Dividends Tax does not apply. When the trustee subsequently exercises a discretion to the effect that the entitlement to the dividend vests in the beneficiary, the resident company exemption cannot be claimed because no provision is made in the Act for claiming such an exemption retrospectively.

When the resident company beneficiary distributes the dividend received from the trust as a dividend to its shareholders, Dividends Tax will again be triggered. Dividends Tax will then have been triggered twice in respect of an amount that is effectively the same dividend.

It might be possible to argue that the trust could make use of the refund provisions contained in s64L and s64M of the Act.

For example, if Dividends Tax had been withheld in respect of the dividend paid to the trust and no exemption was claimed (because at the time the dividend was paid the resident company beneficiary was not entitled to the dividend), the trust could claim the exemption as soon as the entitlement to the dividend vests in the beneficiary by submitting the necessary documents to the company that paid the dividend.

However, it is doubtful whether this mechanism may be used to procure a refund as it was intended to provide relief for beneficial owners who do not claim their exemption in time and not for beneficiaries of discretionary trusts who only become beneficial owners later on once the trustee exercises a discretion to that effect.

In any event, if it is possible to make use of the refund procedure, the exemption will have to be claimed within three years after payment of the dividend.

Vesting trust

In the case of a vesting trust, the situation is much simpler.

Because the beneficiary of a vesting trust is entitled to the trust assets (income or capital) immediately as of the inception of the trust, it seems logical that where a dividend is paid to a vesting trust, the beneficiary will be seen as the beneficial owner of the dividend. This will be the case, not necessarily because of the application of the so-called "flow-through" principle, but because the beneficiary will be absolutely entitled to the benefit of the dividend and therefore meet the requirements of the definition of "beneficial owner" in s64D of the Act. It would be difficult to argue here that the trust and not the beneficiary is the beneficial owner. This is especially so in light of the fact that the very reason it is the beneficial owner, as opposed to the registered or legal owner, who is liable for Dividends Tax, is to avoid being diverted by the formal (and not substantive) approaches to ownership.

The same double taxation problem identified above in respect of a discretionary trust could arise where the trust deed provides that the trust assets will only vest in the beneficiary at a specified future date. Even though it is certain that vesting will take place (as opposed to where vesting depends on the exercise of a discretion), the beneficiary will not be unconditionally entitled to the benefit of the dividend at the time it is paid, but only at a future date. The beneficiary will therefore not be the beneficial owner of the dividend.

However, where the trust assets vest in the beneficiary immediately, but the beneficiary may only claim payment at a future date (ie enjoyment of the benefit of the dividend is postponed, but not the entitlement), then it could be said that the beneficiary is the beneficial owner.

Beneficial ownership

The concept of beneficial ownership has been dealt with by the Canadian courts in the context of international treaties. In the case of *Prévost Car Inc v The Queen (2008 TCC 231 (TC))*, the court said that the beneficial owner of a dividend "*is the person who receives the dividends for his or her own use and enjoyment and assumes the risk and control of the dividend he or she received... In short the dividend is for the owner's own benefit and this person is not accountable to anyone for how he or she deals with the dividend income.*"

In the case of *Velcro Canada Inc v The Queen (2012 TLC57(TC))*, the court emphasised that one must look at who has possession, use, risk and control of the payment. If the recipient has sufficient discretion to deal with the amounts received then that recipient will be the beneficial owner.

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When dealing with Dividends Tax, South African courts will not necessarily have regard to the Canadian courts' interpretation of beneficial ownership. This is mainly because the term "beneficial owner" is specifically defined in s64D of the Act and South African courts will first have regard to the plain meaning of the words used in that definition. Nevertheless, the Canadian approach is rationally sound and a local court will probably adopt a similar view.

In the meantime, taxpayers are anxiously awaiting some guidance from SARS as to how the new Dividends Tax will be applied to trusts.

Heinrich Louw

RULING ON BEE EXPENDITURE

In a recent Binding Private Ruling (BPR 13), SARS was asked to rule on the deductibility of expenditure associated with Black Economic Empowerment (BEE) under the general deduction formula contained in s11(a) of the Income Tax Act, No 58 of 1962 (Act) as read with s23(g) of the Act.

The applicant, a private company resident in South Africa, proposed to address the ownership component of its BEE scorecard by introducing an Equity Equivalent Programme (EE Programme).

In short, the EE Programme entails the following:

- The applicant will invest four percent of its annual turnover, over a period of seven years, in selected qualifying small black owned independent vendors.
- The vendors will incur expenditure in respect of infrastructure, recruitment and employment of black graduates, sales and marketing, software development, training and skills development, traveling and other external services such as legal, accounting, tax, advertising, public relations and management consulting.
- The vendors will be reimbursed by the applicant on presentation of the relevant invoices subject to an agreed allocated budget equal to four percent of the applicant's annual turnover.
- The applicant will not subscribe for equity in the companies of the vendors and the vendors will not necessarily form part of the applicant's existing value chain.

Section 11(a) of the Act, which is phrased positively, allows for a deduction of expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature. Section 23(g) of the Act, its negative counterpart, disallows a deduction of moneys to the extent to which such moneys were not laid out or expended for the purposes of trade.

SARS ruled that the applicant will be entitled to claim the EE Programme expenditure as a deduction under the general deduction formula. The deduction, however, would have to be spread over the relevant years of assessment in terms of s23H of the Act.

Andrew Seaber

DLA CLIFFE DEKKER HOFMEYR

CONTACT US

For more information about our Tax practice and services, please contact:

Emil Brincker
Director
National Practice Head
T + 27 (0)11 562 1063
E emil.brincker@dlacdh.com

Alastair Morphet
Director
T + 27 (0)11 562 1391
E alastair.morphet@dlacdh.com

Natalie Napier
Director
T + 27 (0)11 562 1109
E natalie.napier@dlacdh.com

Ben Strauss
Director
T + 27 (0)21 405 6063
E ben.strauss@dlacdh.com

Johan van der Walt
Director
T + 27 (0)11 562 1177
E johan.vanderwalt@dlacdh.com

Ruaan van Eeden
Director
T + 27 (0)11 562 1086
E ruaan.vaneeden@dlacdh.com

Andrew Lewis
Senior Associate
T + 27 (0)11 562 1085
E andrew.lewis@dlacdh.com

Andrew Seaber
Senior Associate
T + 27 (0)11 562 1768
E andrew.seaber@dlacdh.com

Heinrich Louw
Associate
T + 27 (0)11 562 1187
E heinrich.louw@dlacdh.com

Tessmerica Moodley
Associate
T + 27 (0)21 481 6397
E tessmerica.moodley@dlacdh.com

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BBBEE STATUS: LEVEL THREE CONTRIBUTOR

JOHANNESBURG

1 Protea Place Sandton Johannesburg 2196, Private Bag X40 Benmore 2010 South Africa
Dx 154 Randburg and Dx 42 Johannesburg
T + 27 (0)11 562 1000 **F** +27 (0)11 562 1111 **E** jhb@dlacdh.com

CAPE TOWN

11 Buitengracht Street Cape Town 8001, PO Box 695 Cape Town 8000 South Africa
Dx 5 Cape Town
T + 27 (0)21 481 6300 **F** +27 (0)21 481 6388 **E** ctn@dlacdh.com

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