DLA CLIFFE DEKKER HOFMEYR

BUDGET ALERT

February 2013

Reforming the taxation of trusts: a long time coming

High Net Worth Individuals (HNWI's) and their use of trusts for tax and estate planning purposes go hand in hand. A trust is often praised for its "flexibility". Open any financial planning periodical and there's bound to be an article on the virtue of trusts.

The "trust" concept originated in English law. It has been called "*the most distinctive and creative achievement of English jurisprudence.*" It originated during the 12th and 13th century Crusades. English land ownership was a feudal system. A Crusader leaving England would grant ownership of his estate to a trusted acquaintance upon the understanding that his land would be restored to him upon his return. The King's Courts regarded the Crusader's land as belonging to the trustee who had no obligation to return same. The returning Crusader could, however, petition the King who referred such disputes to the Lord Chancellor. The Lord Chancellor decided matters according to his conscience and so developed the notion of "equity." Over time, the Lord Chancellor's court continuously recognised the returning Crusaders' claims. The principle developed that the legal owner (the "trustee") only held the land for the benefit of the original owner (the "beneficiary") until his return, at which stage the trustee then had to return the land. The term "use of land" was coined and eventually developed into the trust concept.

Local tax principles relating to trusts have been fairly static over the recent past. The fact that trust income attracted a 40% tax rate (and an effective CGT rate of 26.7%) was probably the strongest indicator that the *fiscus* had a jaundiced view of tax planning via a trust.

The topic of trust reform first featured in the 2012 Budget. Mid-2012 SARS announced that research showed that a potentially significant number of HNWI's "*... abused trusts to hide their tax liability.*" Start April Mr. Bob Head joined SARS as special adviser to the Commissioner. In a Business Day article titled "SA strikes right tax balance to address its challenges" (2 April 2012) he wrote: "*Sadly I have never inherited anything and whatever I have I made. I have seen a lot of it disappear in tax. That is just the way it is. I find inherited wealth more difficult to stomach and when the income on that wealth is hidden in trusts and structures to avoid tax, then I really do see red.*"

So HNWI's and their use of trusts have been in SARS's sights for quite some time. The SARS Strategic Plan (2012/13 – 2016/17) stated that there was a "compliance risk posed by high-net worth individuals and the use of trusts to conceal their income." It said that under-declaration of income by persons in the HNWI category (annual income in excess of R7m, alternatively R75m in assets) was wide-spread with "*only a fraction*" actually declaring their income to SARS. The Strategic Plan announced that trust reform would be prioritised. Although there was no detail, it sounded ominous.

Well SA taxpayers now have the detail.

Minister Gordhan referred in his 2013 Budget Speech to "*... various measures proposed to protect the tax base and limit the scope for tax leakage and avoidance.*" One such measure was that "*... the taxation of trusts will come under review to control abuse.*"

In Chapter 3 (p 54) of the 2013 Budget Review the following detail appears:

- Certain aspects of local and off-shore trusts have long been a problem for global tax enforcement due to the flexibility and flow-through nature of trusts;
- The use of a trust to avoid estate duty has also been of concern and will be reviewed;
- The legislative proposals to come will not impact the legitimate needs of minor children and people with disabilities;
- The legislative proposals will bring about certain fundamental changes to the taxation of trusts:
    - Discretionary trusts would no longer be allowed to act as flow-though vehicles. Taxable income and loss (including capital gains and losses) would thus be fully calculated at trust level with distributions to beneficiaries acting as deductible payments to the extent of current taxable income. Beneficiaries will be eligible to receive tax-free distributions, except where they give rise to deductible payments (which will be included as ordinary revenue);

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- Trading trusts will be taxable at the entity level, again with distributions acting as deductible payments to the extent of current taxable income. A trust will be a "trading trust" if it conducts a trade or if beneficial ownership interests in such a trust are freely transferable;
- Distributions received from offshore foundations will be treated as ordinary revenue. This amendment is aimed at schemes designed to shield income from global taxation.

The HNWI constituency was spared a wealth tax and there has been no increase in the maximum marginal tax rate.

However, the envisaged tax amendments will impact the SA trust landscape and could derail many a carefully crafted trust structure.

At least, no-one can complain that no warning had been given.

Johan van der Walt

Share Schemes

Share incentive schemes are once again in the spot light in this year's tax budget proposals. It appears that previous amendments have not satisfied Treasury's concerns on share incentive schemes. Treasury indicates that some staff equity schemes are used as a tool to lower overall tax rates for executives and other-high-income earners. Schemes for lower income taxpayers are sometimes subject to anomalies that may give rise to double taxation.

It thus appears that the broad-based employee share plan contemplated in s8B of the Income Tax Act will be reviewed and possibly merged with s8C of the Income Tax Act into a single employee share scheme regime. Section 8B schemes are not used by many taxpayers owing to the onerous requirements. If the s8C and s8B share scheme provisions are combined, it is anticipated that it will be to the detriment of high-net worth individuals.

It is also indicated that the interrelationship between employer deductions and employee share scheme income will be examined by Treasury. It is anticipated that one of the South African Revenue Service concerns is that taxpayers currently argue that the contributions to the employee share scheme for their employees are deductible (see P*rovider v Commissioner of Taxes, 17 SATC 40*), while the contributions received by the Trust are capital in nature on the basis that the trust is not engaged in a profit-making scheme (see *CIR v Pick 'n Pay Employee Share Purchase Trust 54 SATC 271*).

Andrew Lewis

Cross issue of shares

Section 24B of the Act was initially introduced to deal with the acquisition of assets through the issue of shares. Pursuant to the judgment of *CIR v Labat Africa Limited 72 SATC 75* a company would ordinarily not incur expenditure in connection with the issue of its own shares and thus the need for s24B. Section 24B of the Income Tax Act was recently amended to only deal with the issue of shares in exchange to the issue of shares (ie the cross-issue of shares), being an "anti-avoidance" provision.

Section 24B(2) of the Income Tax Act provides that if a company acquires shares that are issued to that company "*directly or indirectly in exchange for shares issued by that company*", that company incurs no expenditure for the acquisition of the shares issued to it. As a result, the subsequent disposal of the shares by the company may trigger a significant tax liability (ie the tax liability being determined with no tax base).

Treasury have recognised that this anti-avoidance rule is impractical in South Africa, because cross-issues are a common feature of many commercially driven share schemes (especially involving black economic empowerment (BEE) parties). For instance, many BEE transactions were implemented on the basis that the empowerment company (BEE CO) would issue preference shares in the empowered company (OPCO) and use the subscription price thereof to subscribe for ordinary shares in OPCO. Section 24B(2) of the Income Tax Act had the effect that the shares in OPCO would have no base cost, triggering significant adverse tax implications for BEE CO on the disposal thereof.

It will be a welcome relief to taxpayers and advisers alike that the proposal by National Treasury is for these anti-avoidance rules to be reworked. The zero base cost rule will either be eliminated or narrowed. In addition, cross-issues (and share-for-share-transactions) acting as a mechanism to indirectly shift value into tax exempt hands will trigger immediate taxation.

Andrew Lewis

Gateway Subsidiary / Treasury Company

A very interesting proposal by Treasury is to allow South African multinationals to treat a single local subsidiary as a non-resident company for South African Reserve Bank (SARB) purposes and thus promote the establishment of all its treasury operations to remain in South Africa. In other words, it appears that it will effectively be exempt from the exchange control restrictions imposed by the SARB.

National Treasury indicated that it is not uncommon for such South African multinationals to use an offshore subsidiary as a treasury operation as these offshore treasuries could freely move currency without regulatory approval. The SARB regulations thus created an incentive to move the treasury operations offshore, or rather, a disincentive to conduct the treasury operations in South Africa.

It is also indicated that these exchange control exempt entities will be entitled to use their foreign functional currency (eg US Dollars), rather than the South African Rand, as the starting point for their tax calculations.

Andrew Lewis

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Withholding Taxes – Extended to Service Fees

Taxpayers have been anticipating the introduction of a withholding tax on interest paid to non-residents for a number of years now. The effective date for the commencement of the withholding tax on interest will be further delayed from 1 July 2013 to 1 March 2014. The royalty withholding tax to be imposed at a rate of 15% (which is currently imposed at a rate of 12%) will also be delayed until 1 March 2014.

Most significantly, it is proposed that a withholding tax, presumably at a rate of 15%, will be imposed on service fees paid to a non-resident (subject to the applicable treaty relief). The withholding tax on service fees will also be effective from 1 March 2014. It will be interesting to see how the legislature defines "service fees" or "services" to determine how far-reaching this amendment will be.

Andrew Lewis

Retirement Reform

Treasury released a further Consultation Paper together with the Budget documentation. The reform Consultation Paper is trying to bring together the strands of thinking that were set out very clearly in the four papers released by the National Treasury in September/October 2012.

From a tax perspective the critical issues are that Government will proceed with the implementation of tax preferred savings and investment accounts (along the lines of the UK's ISA). All returns accrued on these accounts and any withdrawals would be exempt from tax. The account would have an initial annual contribution limit of R30,000 and a lifetime limit of R500,000, which it is intended to put up in line with inflation. These new accounts will be introduced by April 2015.

At present the current tax free interest income annual thresholds continue, but with effect from 1 March 2013 is put up to R34,500 for individuals 65 years and over, and from R22,800 to R23,800 for individuals below 65 years. These thresholds will not be adjusted for inflation in future.

With regard to individuals' contributions to pension and retirement annuity funds, Treasury is planning to implement legislation, and it is not clear whether this would be effective March 2014 or some time in 2015, in terms of which employer's contributions will be treated as a fringe benefit. Individuals will be permitted to deduct from their taxable income or their employment income up to 27,5% for a contribution to such fund, up to a maximum of R350,000. Last year they were considering having two different scales depending on your age, and have obviously decided to streamline this with one flat rule.

It is further proposed that the annuitisation requirements of pension funds will start to apply to provident funds from a certain date. Existing balances in provident funds and the growth on these, will not be subject to annuitisation. This requirement will not apply to provident fund members older than 55 years at the date of implementation of the new legislation. Government's goal is to reduce the complexity of the retirement system. It is proposed that contributions in excess of the annual cap of R350,000 could be rolled over to future years.

The Consultation Paper indicates that the means test for the old age grant will be phased out by 2016; and the de minimus requirement for annuitisation of retirement funds will be raised from R75,000 to R150,000. It appears from the executive summary that living annuities will be eligible for selection as a default product from a retirement fund, provided that certain design tests set out by the Treasury are met. Trustees that make commission free financial advice available to members on retirement, paid for out of the fund, will be given some legal protection in respect of the choice of default offered to members.

An interesting point is raised under the heading "Taxpayers with multiple sources of income." These people are often faced with high tax liabilities on assessment, because of the aggregation of their incomes. Individual employers and particularly pension funds are typically unaware that there are two or more income streams for an employee or pensioner, and each calculates the PAYE as if there was only one. Government will look to address this during the course of the next year. They are considering either higher levels of withholding by employers (but they acknowledge confidentiality as a concern), holding employees responsible for the PAYE at a higher tax rate to take into account the aggregation effect; SARS informing such taxpayers and suggesting preventative measures, and possibly temporary relief in the case of widows/widowers.

Alastair Morphet

Mineral and Petroleum Royalties

The Mineral and Petroleum Resources Royalty Act of 2008, has been in operation for three years. SARS has indicated that they are concerned about the appropriate specified condition of mineral extraction acting as a reference point on which to calculate the mineral royalty tax base, and the interaction of the royalty regime rate with the income tax calculation and the information reporting requirements under the Royalty Administration Act. The other issue which has drawn a lot of public concern is that the African National Congress at its Manguang conference wanted Government to consider a resource rent tax as a form of super tax when mining companies earn super profits at the height of a commodity cycle. As the President had indicated in his State of the Nation address, the Government has referred these issues concerning what is an appropriate tax for the mining system in South Africa for a broader review by the National Treasury. The Budget review expressly states that an appropriate mining tax regime must ensure that South Africa remains a competitive investment destination. The document says that the royalty regime has broadened the tax base and has allowed for increased revenue during periods of high commodity prices, while providing relief to marginal mines when commodity prices are low.

Alastair Morphet

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VAT registration of foreign businesses

The tax issues associated with e commerce on the Internet remains largely unresolved. Enforcement of tax compliance is generally reliant or can be pin-pointed to geographical areas however in cyber space or the Internet world these geographical boundaries do not exist. The underlying question is whether existing direct and indirect principles can be successfully implemented in imposing and enforcing the taxation of e commerce. E commerce changes things of fundamental importance from a direct and indirect tax perspective. It allows a foreign vendor who essentially has no physical presence to sell into another territory and bypass the payment of any local taxes that may have been imposed on a source basis ie. the purchase of e-books by a consumer or music, where there are no checks in place from a collection mechanism as opposed to the delivery of physical goods that must bypass customs. E commerce has created a whole new way of thinking in terms of creating products previously sold in the form of tangible property, intangible property and services. If existing tax rules are applied there can be a significant change from "technology importing countries" to "technology exporting countries." The obvious issue that arises is what if the foreign vendor is based in a tax haven, does the vendor escape taxation altogether?

It was proposed in the budget speech that in order to curtail foreign businesses who supply goods and services essentially in cyber space from escaping the VAT net that all foreign business supplying digital goods and services will be required to register as VAT vendors in South Africa. This line of thinking follows the current trend adopted by the European Union requiring such suppliers to register for VAT in the country where the consumer resides. The question of whether non residents need to register as vendors in South Africa has been the subject matter of much debate over the years. Generally a person would not be regarded as carrying on a business or other activity in a country unless that person either has a physical presence in the country or the person provides goods or performs services in that country personally or through an agent.

VAT is an indirect tax which applies across the board to almost all supplies of goods and services and is essentially levied at every stage of production and in the distribution chain. The VAT Act provides for the imposition of VAT in respect of the supply of goods and services and on the importation of goods and services. Persons who make taxable supplies in the course or furtherance of an enterprise conducted wholly or partly in South Africa are required to register as vendors, provided the minimum turnover threshold is reached. Vendors collect output VAT from their customers and claim credits for input VAT paid by them.

The immediate problem that arises is enforcement, such as determining the location of the vendor, or where the goods or services were produced or manufactured and/or delivered, establishing what was purchased and where the purchaser is located.

Carmen Moss-Holdstock

Debt restrictions

SARS will once again be focussing on restricting interest deductions on certain debt and debt instruments as it was proposed that certain provisions will be introduced in respect of artificial debt, connected person debt and certain acquisitions of debt.

In a previous Bill provisions regarding the re-characterisation of debt instruments with certain equity features (so-called artificial debt re-characterisation) were introduced. These provisions did however not make it into the final Amendment Act. It is now proposed, without giving any specifics, that debt instruments that will not realistically be repaid within 30 years, or convertible debt-instruments, will be re-characterised as shares and interest deductions in respect of such instruments would therefore not be allowed.

It is noted that these provisions will not apply to banks and insurers, which should provide some relief for those who have issued such instruments in the context of certain funding transactions.

Debt issued to creditors who are connected persons are also to be curtailed in circumstances where the creditor is an exempt entity such as a public benefit organisation. Ordinarily the taxpayer would be able to claim an interest deduction, but SARS cannot tax the exempt entity. It is proposed that deductible interest on such debt does not exceed 40% of earnings, after taking into account other interest. Any excess interest can however be rolled over for up to five years.

The deduction of interest on acquisition debt will also be limited. Companies can often secure large interest deductions in this regard that effectively eliminates their taxable income over a long period. Exact details were not provided and it will be interesting to see how SARS intends to implement this policy decision.

Heinrich Louw

Unlisted REITS

A Real Estate Investment Trust (REIT) is a listed company or property unit trust that invests in immovable property, receives income from rental and pays it through to its investors. In terms of new legislation which becomes effective 1 April 2013, a REIT can deduct such distributions if it resides in South Africa, is listed and at least 75% of its gross income is rental income.

There has been much concern that this regime is going to leave unlisted REITS horribly exposed, particularly when SARS looks to introduce legislation to deal with what is today described as artificial debt. This really relates to the debenture portion of a property linked unit, where the debt instrument is not likely to be repaid in 30 years. SARS are now looking to re characterise some of these debt instruments as shares if they have certain stipulated features. Accordingly, the Budget review indicates that the REITS legislation will look to extend to unlisted REITS provided they are subject to similar regulation as listed REITS. It does not indicate how this

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regulation is going to be introduced (currently the JSE Limited is the regulator of listed REITS). The Treasury would want it to be extended to wholly owned entities of private and Government pension funds, as well as the long term insurers. It appears that they may be considering the legislation to deal with property syndication, because it indicates that REIT tax relief would be extended to cover other real estate entities subject to such regulation. Moreover it indicates that the property syndication legislation needs to protect investors from the Ponzi schemes which we have seen over the last couple of years.

Alastair Morphet

Carbon tax, energy-efficiency savings and the electricity levy

In the 2012/13 Budget, it was proposed, in line with the Climate Change Response White Paper approved by Cabinet in 2011, that carbon tax would be implemented in 2013/14 at a rate of R120 per ton of CO^2 on direct emissions. This rate was to be increased at 10% per annum until 2019/20. The carbon emissions tax would be percentage-based rather than having emissions thresholds.

The 2013/14 Budget proposes implementation of carbon tax effective 1 January 2015 in accordance with the rates suggested in 2012/13, being R120 per ton of CO^2 on direct emissions, increasing at 10% per annum during the first implementation phase. During the first phase of implementation between 2015 and 2020, a basic tax-free percentage threshold of 60% is proposed as previously suggested. Off-set percentages of 5-10% aim to incentivise emission-intensive and trade-exposed industries to invest in and develop emission reducing projects outside of their ordinary operations, thus reducing their carbon tax liabilities.

We await the publication of an updated policy paper by the end of March 2013 for comment and consultation. It is further suggested that some of the revenues generated through the carbon tax will be used to fund energy-efficient savings tax incentives. The implementation of the carbon tax envisages the possibility that the electricity levy will gradually be phased-out.

Government has proposed an extension of the incentive related to the exemption of income from Clean Development Mechanism projects until 31 December 2020, in light of the second commitment period of the Kyoto Protocol.

Danielle Botha

Increase in vehicle CO^2 tax emissions, plastic bag and incandescent bulb levies

This tax encourages consumer to buy vehicles with lower carbon emissions and data shows declining average carbon emissions since its inception. An increase from R75 to R90 for every gram of emissions/km above 120g CO^2/km is proposed. For double cabs an increase from R100 to R125 for every gram in excess of 175g CO^2/km, effective 1 April 2013.

Effective 1 April 2013, it is proposed that plastic bag levies will increase from 4c/bag (since 2009) to 6c/bag; the environmental levy on incandescent light bulbs increasing by R1 per bulb to R4 per bulb.

Danielle Botha

Public-benefit organisations

Previously, donations up to a maximum of 10% of taxable income, made to PBO's in areas including environmental, welfare and humanitarian activities, were deductible. In order to encourage larger donations, a roll-over of donations to PBO's in excess of 10% of taxable income in any given year is proposed and may be deducted in subsequent years.

Rules regarding the funding of PBO's by other PBO's are also under consideration.

Danielle Botha

Increase in Fuel Levies

With effect from 3 April 2013, government proposes to increase the general fuel levy and the Road Accident Fund Levy by 22.5c/l and 8c/l respectively.

Notwithstanding the proposed increases, it must be noted that since April 2010, the general fuel levy included an additional levy component of 7.5c/l for a new multi-product pipeline. This additional levy was included in the general fuel levy to help fund the construction of additional pipeline capacity and was introduced for a period of 36 months. This additional levy component will end on 2 April 2013.

Accordingly, the net increase in the general fuel levy on 3 April 2013 will only be 15c/l and not the full 22.5c/l. Furthermore, the demand-side levy on 95 octane petrol sold inland will be increased on a date to be determined later this year.

Nicole Paulsen

Proposed Gambling Tax

In 2011 government announced a national gambling tax proposal, that with effect from 1 April 2012, all gambling winnings above R25,000, including those from the National Lottery, would be subject to a final 15 per cent withholding tax. It was also indicated that similar gambling taxes exist in India, the Netherlands and the United States. According to the Minister the proposed gambling tax would assist in discouraging excessive gambling in South Africa.

In the 2013 Budget Speech, it was announced that a national tax based on gross gambling revenue of casinos would be introduced at a rate of 1 per cent in addition to the provincial rates. Accordingly, any proceeds derived by a taxpayer from gambling will be subject to an additional 1 per cent levy on top of an existing provincial gambling tax base of 1 per cent.

Although it was announced in the 2012 budget that the proposed tax would be introduced from 1 April 2013, the announcement made in the 2013 budget gives no indication of a specific date but rather states that the proposed gambling tax is to be implemented before the end of 2013.

Nicole Paulsen

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