DLA CLIFFE DEKKER HOFMEYR

# TAX ALERT

22 November 2013

## DISTRIBUTIONS FROM AND DONATIONS TO FOREIGN TRUSTS

On 18 November 2013 the South African Revenue Service (SARS) issued Binding Private Ruling 157 (Ruling).

The Applicant, a natural person and resident, was a beneficiary of two non-resident discretionary trusts A and B. Trusts A and B held various foreign assets such as loan accounts, cash, and shares. Specifically, trusts A and B held all the shares in non-resident companies A and B.

It was proposed that trusts A and B would distribute certain of their foreign assets to the Applicant. Upon receipt, the Applicant would donate the assets to a non-resident trust C.

SARS made the following ruling in respect of the tax consequences relating to the above proposed transaction.

In respect of the loan accounts, cash and shares SARS ruled that s25B(1), (2) and (2A) of the Income Tax Act, No 58 of 1962 (Act) would not apply to the distribution. It is assumed that this is so because these assets are essentially capital assets. It is further also assumed that the assets do not constitute capitalised revenue from prior years of assessment as contemplated in subsection (2A).

In respect of the loan accounts and shares it was also ruled that:

- Paragraph 80 of the Eighth Schedule to the Act would not apply to the distribution (presumably because the disposal by the foreign trust would not trigger a gain for the trust in South Africa, and the Applicant will become entitled to the assets and not any gain or any amount representing a gain).
- The base cost of the assets in the hands of the Applicant should be determined by paragraph 20(1)(h)(vi) of the Eighth Schedule to the Act, in terms of which the base cost would be equal to the market value of the assets on the date of distribution. It is interesting to note that, by implication, SARS ruled that the distribution is one governed by paragraph 38 of the Eighth Schedule to the Act – that is, that the distribution would constitute either a disposal by way of donation, that the consideration was not measurable in money, or that the parties are connected persons and the price was not an arm's length price.

In respect of the donation of the assets by the Applicant to trust C, SARS ruled that :

- The donation would be exempt from donations tax in terms of s56(1)(g)(ii). The implication here is that the Applicant either acquired the assets (situated outside South Africa) by inheritance from a person who, at the time of death, was not a resident, or by way of donation from a person who was not a resident at the time of donation. In other words, the distributions by trusts A and B to the Applicant will be seen as either an inheritance or a donation.

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- The attribution rule contained in s7(8) of the Act will apply. That is, income received by trust C that is attributable to the donation will be attributed to the Applicant. In this regard, and in respect of the shares, the Applicant could claim the foreign dividend exemption contained in s10B(2)(a) of the Act should the 10% participation interest be met. In respect of the loan accounts, any interest on the loans will be attributed to the Applicant. In respect of the cash, interest earned on the cash or amounts arising from investing the cash in an income-generating asset will be attributed to the Applicant.

The ruling is valid for a period of three years.

*Heinrich Louw*

## VAT CONSEQUENCES OF CLAIMING DAMAGES AND COMPENSATION

The South African VAT system is destination based, which means that only the consumption of goods and services in South Africa is taxed. VAT is therefore mainly levied on the supply of goods or services in South Africa.

For a transaction in South Africa to attract VAT, there should be a supply of goods or services by a vendor in the course or furtherance of an enterprise.

To the extent that a supply is a taxable supply, the Value-added Tax Act, No 89 of 1991 (Act) provides for two rates of tax, namely 14% and 0%. The zero rate will apply to the supply of those goods and services that are specifically zero-rated in terms of the Act. While VAT is chargeable at 0% for a zero-rated supply, the vendor making such a supply is nevertheless entitled to claim an input tax deduction.

Certain supplies are exempt from VAT. When the supply of goods or services is exempt no VAT is chargeable. A vendor making an exempt supply cannot claim the deduction of any input tax where the goods or services are acquired in the course of making taxable supplies.

The question that arises is whether the following constitutes a supply that attracts VAT:

- a forbearance to sue; and
- payment of compensation under an agreement.

A supply is defined as including 'all . . . forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is affected…'

The existence of a supply is the critical link for most VAT liabilities arising under the Act. The concept of a supply (and a service) have been explored in case law in New Zealand and South Africa.

In a New Zealand tax case, *S77 (1996) 17 NZTC 7483*, Barber DJ held that an agreement to take no further enforcement steps and to have the proceedings struck was not a supply of goods or services. In this case, the taxpayers were a farming couple who set fire to stubble on their farm. The fire burnt out of control and spread to a neighbouring farm where the fire damaged farm machinery, owned by the L partnership. The taxpayers and the L partnership reached an out of court settlement based on the value of the machinery and costs to the L partnership. The taxpayer sought an input tax credit on the sum paid. The tax authority considered that the surrender was not of itself a supply, as the L partnership did not forgo any legal right; rather, it achieved enforcement of its legal right to damages. Therefore the taxpayer was not entitled to an input tax credit.

Barber DJ commented that although the concept of 'supply' is a very wide one the concept of 'supply' could not cover the situation in the present case, as the L partnership did not supply anything to the taxpayers.

In another New Zealand tax case *T22 (1997) 18 NZTC 8*, Willy DJ discussed the forbearance to sue point. He referred to the Commissioner's policy statement on the "GST treatment of damages and out of court settlements" and made the following comments: *"That [policy statement] appears to me to be a sensible appreciation of the legal consequences of an out of Court settlement in so far as it may impact upon the payment of goods and services tax. One can readily understand how a given settlement may involve the transfer of property which can be 'connected back to the original taxable supplies' and that where a part of the payment relates to the original supply an apportionment of a global settlement sum be required… to go beyond that and assert that the mere forbearance to sue is in some way the provision of goods or a service is on the face of it a surprising proposition"*. Willy DJ was also of the view that although the definition of 'service' was wide, it did not include the forbearance to sue. He considered it could not be said that the taxpayer had provided a service to the Crown merely by choosing to not exercise the existing legal rights.

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In both cases, the Taxation Review Authority of New Zealand decided that a mere forbearance to sue was not a supply.

The question that needs to be asked is to what extent did the person receiving the compensation make any supply in relation to the compensation received. In these instances it seems unlikely that a supply was made and therefore no VAT could be levied.

The views taken by the New Zealand Tax Courts can be contrasted with that of our courts. A case in point is *Stellenbosch Farmers' Winery Ltd v CSARS 2012 (5) SA 363 (SCA)* where it was accepted that the surrender by the taxpayer of its distribution rights constituted a taxable supply of 'services' by it.

It was accepted that by entering into a termination agreement, the taxpayer had supplied a service as defined in Act and that it had surrendered a right as contemplated in the definition of 'services', being the exclusive right to distribute whiskies 41 months before the right would otherwise have come to an end.

A 'service' includes 'anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage…'

The court held that no 'surrender' of a right had in fact taken place and that the company had merely agreed to the expiry date of the right being anticipated and further that the taxpayer had in respect of the surrender of its distribution rights supplied a service to United Distillers Imports (Pty) Limited. The court held that the right which was being surrendered, the surrender of which constitutes the supply of the services, was a constituent part of the services being supplied.

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