DLA CLIFFE DEKKER HOFMEYR

TAX ALERT

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TRUST TAXATION REFORM – WHERE IS THIS HEADING?

High Net Worth Individuals (HNWI's) and trusts have been on the South African Revenue Service's (SARS's) radar for some time.

Reforming the manner in which South African (SA) trusts are to be taxed in future featured in both the 2012 and 2013 Budget speeches. In 2012 Minister Gordhan warned that a potentially significant number of HNWI's "...abused trusts to hide their tax liability." The 2013 Budget speech mentioned "... various measures [are] 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." Chapter 3 (p54) of the 2013 Budget Review pointed out the type of abuse under scrutiny. There was not much detail though.

The Media Statement (4 July 2013) that accompanied the Draft Taxation Laws Amendment Bill and Tax Administration Laws Amendment Bill, 2013 mentioned that certain tax proposals requiring more consultation (eg trust reforms) would be dealt with later this year or as part of the 2014 legislative program. A recent Business Day report (5 August 2013) said that two meetings on the proposed trust tax reforms have taken place between Treasury and stakeholders. It was reported that the Treasury officials were "prepared to listen" to industry concerns but "...the proposed changes to the tax legislation governing trusts and foundations were definitely still under consideration."

There is increasing international co-operation between revenue authorities and they sometimes align their respective compliance initiatives. International developments could therefore shed some light on where the SA trust tax reform (and SARS's accompanying compliance activities) might be heading.

Trusts and how HNWI's use them are also being investigated by the Australian Tax Office (ATO). The ATO released its "Compliance in Focus 2013 - 2014" document on 15 July 2013. That document (p12) deals specifically with the "Misuse of trusts, including omitted income." The ATO makes the following observations:

- There has been significant growth in the use of trusts over recent years (700,000 trusts are currently registered in the Australian tax system) and there have been increased attempts to exploit legal boundaries to reduce tax payable;
- Most of the registered trusts are discretionary trusts used for a wide variety of business and investment activity;
- An emerging type of scheme involves trustees artificially reducing trust income in an attempt to direct tax liabilities to certain beneficiaries (who have little or no capacity to pay the debt); and
- A new 'Trusts Taskforce' will focus on the above, including other tax avoidance and evasion schemes.

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The Trusts Taskforce documentation on the ATO website indicates:

- The ATO's recent compliance operations have detected increased manipulation of trusts as vehicles at the centre of tax avoidance or evasion arrangements;

- The 2013-14 Federal Budget will provide $67.9m (ie R650m) over four years for the ATO to audit taxpayers involved in tax avoidance or evasion using trusts;

- The Taskforce's focus will be on people exploiting trusts to conceal information, mischaracterise transactions and artificially deal with trust income to avoid/reduce tax; and

- Tax scheme promoters, individuals and businesses who participate in such arrangements will also be targeted through eg the ATO's "intelligence systems, including new tax return labels."

According to the ATO the following will be "some of the factors that will attract our attention", ie arrangements where:

- Trusts or their beneficiaries (who have received substantial income) are not registered, or have not lodged tax returns or activity statements;

- There are offshore dealings involving secrecy jurisdictions;

- Agreements with no commercial basis appear to be in place so as to direct income entitlements to a low-tax beneficiary while the benefits are enjoyed by others;

- There is artificial characterisation of amounts, eg the tax outcomes do not reflect the economic substance resulting in some parties receiving substantial benefits from a trust while the tax liabilities corresponding to such benefit are attributed elsewhere;

- There has been mischaracterisation of revenue activities to achieve concessional CGT treatment – eg by using special purpose trusts to attempt to re-characterise mining or property development as discountable capital gains;

- Changes have been made to trust deeds to achieve a tax planning benefit, and are not credibly explainable for non-tax reasons;

- Transactions have excessively complex features or sham characteristics, e.g. round robin circulation of income among trusts; and

- New trust arrangements have materialised that involve taxpayers and/or promoters who have histories of, or connection to, previous non-compliance – eg people connected to liquidated entities that had unpaid tax debts.

The ATO expressly states that the Taskforce intends targeting higher risk taxpayers, but that its investigations would exclude ordinary trust arrangements and tax planning associated with genuine business or family dealings.

It is still 'early days' when it comes to the South African reform of the taxation of trusts. Nevertheless, local HNWI's should perhaps use the time at hand to get their (trust) ducks in a row – especially if developments down under are an indication of where SA might be heading?

Johan van der Walt

CAPITAL GAINS TAX ON REDUCTION OF INTEREST RATE

The South African Revenue Service (SARS) recently published a ruling dealing with the question as to whether the cancellation and extinguishment of a right to claim interest on a shareholder loan will trigger a capital gains tax (CGT) liability *(Binding Private Ruling: BPR 152).*

CGT arises when a person disposes of an asset. The term 'disposal' is defined widely in the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Schedule). In particular, in terms of paragraph 11(1)(b) the "forfeiture, termination, redemption, cancellation, surrender, discharge, relinquishment, release, waiver, renunciation, expiry or abandonment of an asset" constitutes a disposal for CGT purposes.

The facts of the ruling were the following: A Ltd (A) bought 74% of the shares in B (Pty) Ltd (B). A and B were not connected parties before the share purchase. In other words, they were acting at arm's length.

B owed about R4 billion to a financier in terms of an interest-bearing loan claim. As part of the share purchase, A also acquired that claim for a price of about R1 billion. B continued to owe A the full amount of R4 billion. However, B was not in a position to service the interest on the claim.

A proposed that the claim be split in two: A would continue to charge interest on the R1 billion portion of the claim. A would however stop charging interest on the R3 billion balance of the claim.

First, SARS ruled that as A and B were not connected persons before A acquired the shares in B, the price of R1 billion represented an arm's length price. Now, it is not immediately apparent why a ruling was necessary in respect of this aspect. In terms of paragraph 38 of the Schedule (which SARS referred to in its ruling), if a person disposes of an asset to another person who is a connected person in relation that person for a consideration that is below an arm's length price, then the proceeds of the disposal are, for CGT purposes, deemed to be the market value of the asset. However, in circumstances of the ruling, A did not acquire the claim from B. Accordingly, the provisions of paragraph 38 of the Schedule would not have been applicable, even if A and B were connected persons in relation to each other before the sale transaction.

Second, SARS ruled that the cancellation and extinction of A's right to interest did not trigger CGT for A. While it was appropriate for the taxpayers in this case to have applied for a ruling for the sake of certainty in the light of the big amount of money involved, it is in my view not apparent that the reduction of the rate of interest of a loan is a disposal for CGT purposes.

SARS is of the view that the cancellation of a contract as such is a disposal for CGT purposes (see, for example, SARS's *Comprehensive Guide to Capital Gains Tax* (issue 4) at page 287). However, consider the case where a bank agrees with a debtor to reduce the rate of interest from 8% per year to 7% per year. In my view, it would be anomalous to suggest that the bank has, in principle, made a disposal for CGT purposes because it has 'cancelled' or 'relinquished' the right to some interest. On the strength of the decision in *Income Tax Case No 1859* 74 SATC 213, I would suggest that a creditor who reduces the rate of interest is not making a disposal to any person, and accordingly no CGT should arise – even if the creditor reduces the rate to nil.

However, even if the reduction of the rate of interest by a creditor is a disposal for CGT purposes, practically the disposal ought to have no negative CGT consequences as the creditor would be receiving no proceeds. In terms of paragraph 35(1)(a) of the Schedule the proceeds on disposal of an asset include "the amount by which any debt owed by that person has been reduced or discharged." However, that provision would not apply where the rate of interest has been reduced prior to the interest accruing because there is no debt owing which has been reduced or discharged. In fact, if the reduction of the rate of interest is a disposal for CGT purposes, the creditor could even argue that he has realised a capital loss!

What the ruling does show is that both taxpayers and SARS are still grappling with the issue relating to the extent to which the cancellation or variation of an agreement gives rise to CGT.

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