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TAX AND EXCHANGE CONTROL ALERT

IN THIS **ISSUE**

CDH
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WILL TRUSTS STILL BE THE WAY TO GO? THE NEW SECTION 7C PROPOSED BY THE DRAFT TAXATION LAWS AMENDMENT BILL

Section 7C(1) states that the section will only apply to natural persons where that person and a trust are connected persons and apply to companies who are connected persons in relation to such natural persons or to the trust.

For a number of years, National Treasury indicated that it intended tightening up the tax provisions applicable to trusts. On 8 July 2016, the Draft Taxation Laws Amendment Bill (Draft TLAB) and the Explanatory Memorandum on the Draft TLAB (Explanatory Memorandum) were released by National Treasury. The Draft TLAB proposes to introduce a new s7C into the Income Tax Act, No 58 of 1962 (Act), which will have far-reaching tax consequences for trusts and persons utilising trusts as an investment vehicle, if it is enacted in its present form.

In response to the reduction of the tax base created by such arrangements, the Draft TLAB proposes to insert s7C into the Act.

The use of interest-free loans to a trust

Currently, the sale of assets to a trust which is financed by way of an interest-free loan does not trigger any adverse tax consequences for the seller or the trust. According to the Explanatory Memorandum, the benefit of this is that a seller who is a natural person can extinguish the loan by making use of the annual R100,000 exemption from donations tax, in terms of s56(2)(b) of the Act (persons other than natural persons enjoy an annual exemption of R10,000 in terms of s56(2)(a)). The financing of the asset in this manner is also beneficial from an estate duty perspective as the seller's asset base is reduced tax-free through the use of the annual exemption from donations tax. As no interest is payable in terms of the loan, the tax base is further reduced.

The impact of the proposed s7C on the tax treatment of interest-free loans to a trust

In response to the reduction of the tax base created by such arrangements, the Draft TLAB proposes to insert s7C into the Act.

Firstly, s7C(1) states that the section will only apply to natural persons where that person and a trust are connected persons and apply to companies who are connected persons in relation to such natural persons or to the trust. Secondly, for s7C to apply such a natural person or company or connected persons in relation to them must directly or indirectly provide a loan, credit or advance to the trust.

To address the avoidance of interest accruing to the seller or lender, s7C(3) states that if no interest accrues to the seller or lender or it accrues at a rate lower than the official rate of interest, as contemplated in the Seventh Schedule to the Act, the difference between the amounts will be included in the taxpayer's income. In addition, s7C(4) states that the seller may recover this amount from the trust and if it is not recovered by the seller or lender within three years from the end of the year of assessment in which the loan is extended, it will attract donations tax.

Furthermore, s7C aims to prohibit a natural person from applying the interest exemption in s10(1)(i) of the Act to such interest, in terms of the Explanatory Memorandum. According to the

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Section 7C will not outright prohibit a natural person from applying the annual donations tax exemption to a donation to the trust. Section 7C(5) states that s56(2) of the Act does not apply "in respect of any amount owing in respect of a loan, advance or credit contemplated in subsection (1) that is disposed of under a donation".

Explanatory Memorandum, the trust will only be allowed to deduct the interest paid if the payment of such interest complies with the general deduction formula in s11. This appears to be the intention of s7C(2), which states that no deduction, loss or allowance may be claimed in respect of a disposal, including by way of reduction or waiver, or in respect of the failure of a claim for the payment of any amount owing in respect of a loan, advance or credit.

To address the avoidance that occurs whereby the annual exemption of R100,000 for donations tax available to natural persons is used by the seller to settle the outstanding loan, s7C(5) states that s56(2) of the Act, which contains the exemption provision, does not apply to any amount owed on loan account that is disposed of under a donation.

Analysis and comment

Paragraph 1 of the Seventh Schedule to the Act defines the official rate of interest as a rate of interest equal to the South African repurchase rate (repo rate) plus 100 basis points, where a debt is denominated in rand. Based on the current repo rate of 7%, it means that the official rate of interest is currently 8% where a debt is denominated in rand. For purposes of s7C(3), the effect of this provision is that if a natural person and a trust are connected persons and the trust owes R200,000 to the person on loan and no interest is payable in terms of the loan, an amount of R16,000 (R200,000 x 8%) will be included in the income of that person.

Furthermore, s7C has the potential of taxing the seller or lender twice, by not only including the amount in the income of the lender or seller if the loan is made at a rate below the official rate of interest, but by also causing that person to incur a donations tax liability should this amount not be recovered by the seller within three years after the year of assessment in which it accrued to him or her. In terms of the example used in the previous paragraph, an additional R3,200 (R16,000 x 20%) would be payable by the natural person.

Interestingly, s7C will not outright prohibit a natural person from applying the annual donations tax exemption to a donation to the trust. Section 7C(5) states that s56(2) of the Act does not apply "in respect of any amount owing in respect of a loan, advance or credit contemplated in subsection (1) that is disposed of under a donation". This means that if a natural person donates an asset worth less than R100,000 to a trust in relation to which he or she is a connected person, s7C will not apply and no interest will be deemed to have accrued to that person in terms of s7C(3).

If it is enacted in its current form, s7C could very well deter persons from using the trust as a vehicle for tax avoidance in future. Taxpayers should keep in mind, however, that s7C will not affect the established principles applying to trust law such as the conduit-pipe principle. In a nutshell, the conduit-pipe principle states that any income that accrues to or is received by a trust on behalf of its

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The Draft TLAB states that s7C will come into effect on 1 March 2017, but it is not clear whether it will also apply to interest-free loans that were made before this date, if enacted in its current form.

beneficiaries will not be taxed in the hands of the trust, but only in the hands of the beneficiaries, provided that it vests in the beneficiaries in the year of assessment in which it accrued to the trust. For example, if a trust beneficiary sells property to that trust, s7C will apply to that sale if the property is sold on loan account. However, any income received from the rental of that property to a third party, will not be taxed in the hands of the trust, but in the hands of the beneficiary, provided that the income vests in a trust beneficiary in the year of assessment in which the amount accrues to the trust.

The Draft TLAB states that s7C will come into effect on 1 March 2017, but it is not clear whether it will also apply to interest-free loans that were made before this date, if enacted in its current form.

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TAX EXEMPTION OF MEMBERSHIP BASED ORGANISATIONS – TIME FOR A RETHINK?

Section 30B organisations are therefore finding it progressively more difficult to comply with the 85% funding threshold as they do not receive any funds from government and cannot maintain sufficient membership fees.

Membership based organisations are fundamental to the sustainability and development of the economy of South Africa as they provide vital industry and professional support services to a wide range of important occupations and trades ranging from accountants, lawyers and doctors to artisans and engineers. The majority of these organisations operate on a non-profit basis for the benefit of their members and ultimately play an important role in increasing employment in South Africa and uplifting poor communities.

One could make the argument that fees derived from the provision of training and educational programmes would not ordinarily fall within the ambit of funding derived from annual or other long term members and hence would fall outside the 85% funding requirement, placing the organisation in jeopardy of relinquishing its tax exempt status.

Section 10(1)(d)(iv)(bb) of the Income Tax Act, No 58 of 1962 (Act) therefore provides for the exemption of the receipts and accruals of any company, society or other association of persons established to promote the common interests of persons (being members of such company, society or association of persons) carrying on any particular kind of business, profession or occupation which has been approved by the Commissioner of SARS under s30B of the Act.

Section 30B of the Act, essentially sets out the requirements that such organisations must comply with in order to receive approval from SARS as a tax exempt organisation. Section 30B(2)(b)(ix) of the Act specifically requires that in order to be approved as a tax exempt association in terms of s10(1)(d)(iv)(bb), read with s30B, the founding document of the organisation must provide that "substantially the whole of the entity's funding must be derived from its annual, or other long term members or from an appropriation by the Government of the Republic in the national, provincial or local sphere". While "substantially the whole" is not explicitly defined in the Act, it is a well-accepted principle that it means 85% or more.

In an increasingly inter-connected and globalised world, the attractiveness of membership-based organisations and the willingness of members to pay membership fees is becoming increasingly less. Section 30B organisations are therefore finding it progressively more difficult to comply with the 85% funding threshold as they do not receive any funds from government and cannot maintain sufficient membership fees. As a result, many organisations have begun to look elsewhere to source their funding including receiving fees for the provision of educational activities and training to members (and non-members) on an ongoing and ad hoc basis.

The provision of training and education by such organisations to their past, present and future members (and in some cases non-members) provide a variety of important functions including ensuring that all members are adhering to certain principles of conduct, remaining up to date with ever-changing professional standards and governing legislation, and ensuring that the training received by its members is of an international standard. However, one could make the argument that fees derived from the provision of training and educational programmes would not ordinarily fall within the ambit of funding derived from annual or other long term members and hence would fall outside the 85% funding requirement, placing the organisation in jeopardy of relinquishing its tax exempt status.

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TAX EXEMPTION OF MEMBERSHIP BASED ORGANISATIONS – TIME FOR A RETHINK?

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Such membership based organisations could maintain their tax exempt status by not falling foul of the 85% funding requirement and in addition, any receipts or accruals derived from the provision of education and training to its members (or otherwise) on a cost-recovery basis would also potentially not be taxable.

Notwithstanding this, most of the organisations provide such education and training on a non-profit cost-recovery basis, and one could therefore argue that such receipts should in any event not be taxed. To the extent that the policy is not to tax such organisations on these receipts, then there may be merit in extending the partial taxation regime currently governing public benefit organisations to membership based organisations. In this way, membership based organisations could maintain their tax exempt status by not falling foul of the 85% funding requirement and in addition, any receipts or accruals derived from the provision of education and training to its members (or otherwise) on a cost-recovery basis would also potentially not be taxable.

Furthermore, any receipts derived from trading activities would become taxable, while not placing the overall tax exempt status of the organisations in danger of being withdrawn. This solution would be very beneficial to not only the sustainability of membership based organisations but to the general public as a whole.

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CUSTOMS AND EXCISE HIGHLIGHTS

Please note that this is not intended to be a comprehensive study or list of the amendments, changes and the like in the Customs and Excise environment, but merely selected highlights which may be of interest.

In the event that specific advice is required, kindly contact our Customs and Excise specialist, Director, Petr Erasmus.

Below are selected highlights in the Customs and Excise environment since our last instalment.

Draft Rule Amendment Notice in terms of s64D and s120 relating to the movement of newly imported vehicles from depot to bonded facility:

1. Comments are invited on the updated draft amendment notice by no later than 19 August 2016.
2. Comments received on the previous draft Rule Amendment Notice, published on 3 June 2016, were considered. The amendments require a further publication for comment.
3. The proposed amendments read as follows (words in bold type in square brackets indicate omissions from existing rules and words underlined with a solid line indicate insertions in existing rules):

   Rule 64D.04 is hereby amended by:

   (a) the substitution for the words in paragraph (f) preceding subparagraph (i) of the following words:

   "(f) the importer of the goods or the **[a]** licensee of any premises, including any customs and excise warehouse licensed under any provision of this Act, using own transport";

   (b) the substitution for paragraph (fA) of the following paragraph:

   "(fA) a [licensee of a customs and excise storage warehouse who removes in bond or exports a] second-hand road vehicle is removed in bond or exported by the licensee of a customs and excise storage warehouse as contemplated in rule 18.15 and 18A.10, respectively";

   (c) the insertion after paragraph (fA) of the following paragraph:

   "(fB) an imported new road vehicle is removed, using own transport, on a road vehicle designed for the transport of vehicles or under its own power by the importer of the vehicle or the licensee of a customs and excise warehouse"; and

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CUSTOMS AND EXCISE HIGHLIGHTS

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Reduction in duty on "Cane or beet sugar and chemically pure sucrose, in solid form" of heading 17.01.

(d) the addition of the following subrule:

"(2) For purposes of subrule (1)(fB):

"road vehicle" has the meaning assigned to it in rule 18.15(e); and

"using own transport" in relation to:

(a) the removal of an imported road vehicle on a road vehicle designed for the transport of vehicles, means using a vehicle for such transport which is:

(i) owned by the person permitted to transport in terms of paragraph (fB), including a vehicle in possession of that person in terms of a hire purchase or vehicle lease agreement; or

(ii) rented by that person for the purpose of such transport, and driven by a person under the direct instructions of the person permitted to transport; and

(b) the removal of an imported road vehicle under its own power, means using a driver under the direct instructions of the person permitted to transport in terms of paragraph (fB), either:

(i) as an employee of that person; or

(ii) as a person contracted by that person for the purpose of driving the imported vehicle."

Reduction in duty on *"Cane or beet sugar and chemically pure sucrose, in solid form"* of heading 17.01.

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BBBEE STATUS: LEVEL THREE CONTRIBUTOR
Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 3 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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