

📌 **The new ruling in the amendment to South Africa's Income Tax Act ('the Act') is found under Section 7C and is operative from 1 March 2017.** 📌

NEW TAX ON LOANS TO TRUSTS

By JOHAN GREYLING

A new insert in the recently amended Income Tax Act sees interest-free and low-interest loans to trusts now made subject to donations tax of 20%. And not only does it apply to loans made from 1 March 2017, but also targets existing agreements. The good news is that there is possibly some relief.

A heads-up to all our clients: those who have made, as well as those who are considering making interest-free or low-interest loans to trusts must take note of an inclusion by way of the latest *Taxation Laws Amendment Act 16 of 2016* which makes tax payable on loans, advances or credit to trusts.

The new ruling in the amendment to South Africa's Income Tax Act ('the Act') is found under Section 7C and is operative from 1 March 2017. Most notably, it not only applies to loans, advances or credit given from this date, but also affects existing agreements.

Two types of transactions are specifically targeted:

- Interest-free or low-interest loans, credit or advances made to a trust directly or indirectly by a natural person or a company in relation to which that person is connected by holding an aggregate interest of at least 20%;
- Deductions, losses or capital losses claimed in respect of disposals (including reductions or waivers) or the failure to claim payment (in whole or in part).

With regard to interest-free or low-interest loans, the interest concession, being the difference between the actual rate of interest levied on the loan and the official rate of interest (currently 8% per annum), will be deemed to be a donation in the hands of the lender and subject to donations tax of 20%. The interest foregone will be treated as an ongoing annual donation made to the trust on the last day of the year of assessment of the trust.

The official rate of interest is defined by the legislator in Paragraph 1 of the Seventh Schedule to the Act, which links it to the repurchase (repo) rate with the addition of 100 basis points. The repo rate

has been 7% since 18 March 2016 (the date of the amended Act), thus making the current official rate of interest 8% per annum.

With regard to disposals or the failure to claim payment in respect of loans, credit or advances where interest is levied at a rate of less than the official rate of interest, no revenue or capital loss associated with that loan, advance or interest may be claimed by the lender.

INSTANCES WHERE SECTION 7C WILL APPLY

Examples of indirect loans, advances or credit subject to Section 7C include amounts vested by a trust in a trust beneficiary which is not distributed to the beneficiary, provided that the non-distribution resulted from:

- An election exercised by the beneficiary;
- A request by the beneficiary that the amount not be distributed.

In instances, however, where distributions are withheld solely at the discretion of the trustees, such amounts will not fall within the application of Section 7C. This would, for example, be the case when an amount is vested irrevocably by a trustee in a trust beneficiary and is used or administered for the benefit of the beneficiary without a distribution or payment to the beneficiary, provided that the trust deed specifies that:

- The amount not be distributed to the beneficiary, eg before the beneficiary reaches a specific age;
- The trustee has the sole discretion as regards the timing and extent of any distribution to the beneficiary of such vested amount.

OTHER INSTANCES WHERE SECTION 7C WILL NOT APPLY

The most notable exclusion to the application of Section 7C in respect of traditional trusts is that it will not apply to loans, credits or advances which are wholly or partly used to fund or acquire a residence that is used throughout that year of assessment by the lender or his/her spouse as a primary residence, as defined by the Eight Schedule to the Act.

Other exclusions are also available in respect of:

- Special trusts created solely for the benefit of minors with disability;



- Loans made by a trust beneficiary of a vesting trust, provided that certain qualifying provisions are met (the rationale being that the vested interest of the beneficiary in the assets and receipts or accruals of such trust will form part of that beneficiary's estate, which is the aim of the provisions of section 7C);
- Trusts that are approved public benefit organisations or qualifying small business funding entities;
- Affected transactions dealt with by Section 31 of the Act (transfer pricing);
- Qualifying Sharia-compliant financing arrangements;
- Loans subject to the provisions (value-extracting) of section 64E of the Act.

RELIEF VIA DONATIONS TAX EXEMPTION

Some relief to the payment of tax in accordance with Section 7C may however be available through the application of the annual donations tax exemption of R100 000. Contrary to the provisions contained in the draft bill released earlier in 2016, the annual donation allowance of R100 000 may be applied towards the deemed donation imposed as a sanction by the insertion of section 7C.

CASE STUDIES

Here are two examples to illustrate the tax liability following from a loan, advance or credit subject to Section 7C. The results show that, with the advent of Section 7c, due consideration must be given as to whether or not interest should be charged on a loan, advance or credit to a trust.

Example 1:

A loan in the amount of R10 million is advanced by an individual to a trust at no interest, with the individual choosing to apply his annual donation exemption to this deemed donation:

- The deemed donation will be R800 000 (R10 million x 8%).
- The donations tax liability will be R140 000 (R700 000 x 20%; the donation exclusion being R800 000 - R100 000).

Example 2:

A loan in the amount of R10 million is advanced by an individual to a trust with interest levied at a rate of 5% per annum where the individual has either chosen not to utilise, or has already depleted their donation exclusion:

- The deemed donation will be R300 000 (R10 million less x 3%; the latter being the difference between the rate of interest levied and the official rate of interest).
- The donations tax liability will be R60 000 (R300 000 x 20%).

The important consideration illustrated by the above examples is that, from a commercial perspective, one must weigh up the implications of the sanctions imposed by Section 7C versus the consequences of charging interest at the official rate.

In the first example, the trust will have additional funds in the amount of R800 000 available (which would otherwise have been paid out as interest), while the lender will suffer a tax liability of R140 000.

In the second example, a consideration not taken into account is the income tax liability which would be levied on the R800 000 interest income received by the lender. Taxed at the 41% bracket, this would result in a tax liability of R318 242 (R800 000 - R23 800 annual interest exemption x 41%).

CONCLUSION

We suggest that, to ensure effective tax planning, clients obtain specific advice when considering amending existing trust deeds or effecting amendments to existing loan agreements between qualifying persons and trusts.

Johang@stbb.co.za

