



Dissertation

In respect of the proposed topic:

THE TAXATION OF TRUSTS IN SOUTH AFRICA:  
CRITICAL ANALYSIS OF SECTION 7C

SUBMITTED TO THE UNIVERSITY OF CAPE TOWN

In partial fulfilment of the requirements for the degree of  
Master of Commerce (South African Taxation)

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# Abstract

The purpose of this dissertation was to critically analyse the recently introduced section 7C of the Income Tax Act, 58 of 1962 (ITA) with the aim of determining whether section 7C achieved its stated objective. Although aimed at tax abuse through the use of trusts, the section is a further limitation on trusts, a vehicle that has been affected by numerous legislative amendments over the past couple of decades.

The introduction of section 7C of the ITA is directly in line with the existing section 7 as well as international trends including the Base Erosion and Profit Shifting (BEPS) final reports. As globalisation accelerates and data becomes more readily available to both developed and developing economies the transparency of structures will become more evident and the previously utilised loopholes will close. Additionally, the current economic downturn in South Africa (SA), and globally, is likely to result in more aggressive revenue authorities.

Taxpayers will have to ensure that they receive appropriate advice and that tax is considered at the outset of structure development opposed to being an afterthought following the commercial agendas.

Further, there is currently room for the application of sections 7C, 7(5) and 7(8) simultaneously in specific circumstances which may result in the application of both donations and income tax. The question remains as to whether the application of these section is fair and/or correct. I think it is probably difficult to argue that it is not at this stage.

Finally, it is submitted that the question raised by this dissertation – does section 7C of the ITA achieve its stated objective (the prevention of tax evasion through interest free loans) has been answered in the affirmative.



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## Abbreviations

BEPS	Base Erosion and Profit Shifting
DTC	Davis Tax Committee
Draft TLAB	Draft Tax Law Amendment Bill, 2017
EDA	Estate Duty Act, 45 of 1955
G20	An international forum for the governments and central banks of various countries
ITA	Income Tax Act, 58 of 1962
MTBPS	Medium Term Budget Policy Statement
MNE	Multinational enterprise
OECD	Organisation of Economic Co-Operation and Development
PN7	Practice Note 7
SA	South Africa
SARS	South African Revenue Service
TAA	Tax Administration Act, 28 of 2011
TLAB2017	Tax Law Amendment Bill, 2017
TPCA	Trust Property Control Act, 57 of 1988
VAT	Value-Added Tax
VOC	Dutch East India Company



# Chapter 1: Introduction

- 1 Introduction
- 1.1 Background
- 1.2 Research objective and limitations
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# Chapter 1: Introduction

## 1.1 Background

On 19 January 2017 section 7C was introduced to the ITA by the Taxation Laws Amendment Act No. 15, 2017 and is effective as of 1 March 2017. The section aims to control the use of certain interest free loans to trusts. Although aimed at tax abuse through the use of trusts, the section is a further limitation on trusts, a vehicle that has been affected by numerous legislative amendments over the past couple of decades.

Trusts are often used as vehicles to hold assets as against holding them in companies, partnerships, close corporations or holding them personally generally due to the following reasons: estate planning, asset protection, limited liability, perpetual succession and taxation benefits.

In terms of common law a trust is not a separate legal persona which has independent rights and obligations including taxation obligations. Trusts, at common law, are merely an accumulation of assets and liabilities. Trusts, as defined in the Trust Property Control Act, 57 of 1988 (TPCA), are arrangements through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed to another person, including but not limited to the trustees or beneficiaries of such trust.

In relation to the taxation of trusts, the South African legislature has for some time been focused on limiting the tax advantages available to trusts and curbing the “tax abuse” being achieved by individuals and taxpayers generally through the use of trusts. The latest introduction of section 7C is an example of this.



As mentioned above, one of the main reasons taxpayers make use of trusts is for estate planning purposes. By transferring the assets out of the hands of the taxpayer into a trust, they are no longer taxable in his or her hands, whether it be income tax, corporate tax, value-added tax (VAT) or transfer duty. Taxpayers often take advantage of the future benefits provided by trusts by disposing of an asset to a trust for a market related consideration while no actual cash is paid, the balance is left on an interest free loan account. The benefit is that the taxpayer is never taxed on the subsequent growth of an asset transferred to a trust and that any income or capital growth accrues to the trust. The interest free loan is the exact mechanism which 7C now restricts. It effectively taxes a founder or lender in advance on the “growth” of the transferred asset, represented by the deemed interest, the rationality being that the founder or lender, by having a loan with the trust, still has control over the asset<sup>1</sup>.

## 1.2 Research objective and limitations

This dissertation aims to critically analyse the recently introduced section 7C of the ITA with the aim of determining whether section 7C achieves its stated objective. Additionally, the thesis analyses the interaction with transfer pricing principles including section 31 of the ITA.

A detailed analysis of the taxation of trusts in SA including detailed legislative quoting is excluded.

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<sup>1</sup> Personal view of author.



### 1.3 Research method

The research method utilised in the preparation of this dissertation is doctrinal research.

Doctrinal research is described as “the traditional or ‘black letter law’ approach and is typified by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary.”<sup>2</sup>

Applying the doctrinal methodology an extensive review of case law, the relevant sections of the relevant legislation including Acts, interpretation notes and commentary was performed.

Additionally, the history of the trust generally, as well as the taxation of trusts is explored and analysed. Policy, case law and legislative developments in SA is all included and used to conclude on the research objective.

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<sup>2</sup> McKerchar, M. 2008. Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation. *eJournal of Tax Research*. [Electronic], 6(1): 5-22. Available at: <http://www.austlii.edu.au/cgi-bin/viewdoc/au/journals/eJTR/2008/1.html#Heading183> – accessed June 2017



## Chapter 2: Trusts

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# Chapter 2: Trusts

## 2.1 A brief history of trusts

In SA, the concept of a trust originated from the English trust. South African law is generally based on Roman-Dutch law however due to British occupation of SA there are elements of English law which have been incorporated through court cases and formal legislation. "The trust was developed by the English Court of Chancery from the Germanic Salmon or Treuhand institution rather than from the Roman fideicommissum or other juridical institutions of Roman law."<sup>3</sup>

There are a number of theories as to how the English trust came into being, the Treuhand is merely one. This dissertation does not aim to examine the origin of the English trust but proceeds on the basis that South African trusts are based on English trusts and briefly examines the English trust itself and its adoption in SA.

## 2.2 The origin of trusts in SA

As mentioned above, South African law is generally based on Roman-Dutch law, otherwise known as common law, and has been developed by the formalisation of legislation, court decisions as well as the introduction of English law concepts during both British occupations of SA.<sup>4</sup>

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<sup>3</sup> *Braun v Blann and Botha* 1984 (2) SA 850 (A)

<sup>4</sup> Geach, W; Yeats, J "Trusts Law and Practice" 2007 at p11 (Geach)



Trusts were not a known concept in Roman-Dutch law although testamentary trusts had been regarded as a *fideicommissum* in SA prior to the *Braun* case.<sup>5</sup>

In *Braun* the court distinguished between a *fideicommissum* and a trust, which it held to be a separate and distinct legal vehicle. Additionally, it held that “it is one of the functions of our law to keep pace with the requirements of changing conditions in our society. To recognise the validity of conferring our common law powers of appointment on trustees to select income and/or capital beneficiaries from a designated group of persons would be a salutary development of our law of trusts and would not be in conflict with the principles of our law. The approach of our Courts is to apply the principles of our law to the development of our law of trusts.”

Further use of English trusts in SA by English trained practitioners through the drafting of wills and deeds resulted in the need for interpretation.<sup>6</sup> Such interpretation inevitably ended up in front of court judges raising questions regarding trusts generally, their enforceability in SA and whether incorporation into South African legislation should, or could, be drafted.<sup>7</sup> As it stands today, English trust law in its original state was never incorporated into South African law. Through the application of SA’s common law to the English trust South African judges have through their court decisions, created a unique South African trust law which is significantly different to the original English law trust on which it is based.

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<sup>5</sup> *Braun v Blann and Botha* 1984 (2) SA 850 (A)

<sup>6</sup> Honniball, M; Olivier, L *The Taxation of Trusts in South Africa* 2009 at p3 (Honniball)

<sup>7</sup> *Estate Kemp v MacDonald’s Trustee* 1915 AD 491



## 2.3 Developments within trust law in SA

As mentioned in section 2.2 above SA has a hybrid legal system made up of Roman-Dutch law as well as English common law. Common law is derived from custom and judicial precedent rather than statutes. Through its common and wide application over time it can become part of that jurisdiction's law or legal system.

While trusts were governed by common law and court precedent the vehicle was increasingly being used in different ways to which it was initially intended, which was to hold and protect assets. Additionally, trusts became more complex as financial transactions became more complex. This provided an opportunity for taxpayers to plan their tax affairs to limit various taxes, amongst other advantages.

As a result various groups, including the South African Revenue Service (SARS), called for greater regulation of trusts in SA, including the drafting and implementation of legislation. The following two sections explore briefly the pre and post legislative developments in South African trust law.

### 2.3.1 Pre-legislative developments

There are three distinct periods in SA's history which had material and significantly different impacts on the development of SA's legal system. Quoted in a number of cases Hahlo and Khan described these periods as:

- Firstly, the 143 years from 1652 to 1795, during which time the Cape was under the control and occupation of the Dutch East India Company (**Dutch occupation**);



- Secondly, the British occupation from 1795 to 1910, with a brief break between 1803 and 1806 (**British occupation**); and
- Thirdly, from 1910 onwards (**Recent pre-legislative past**).

In 1652 Jan van Riebeeck of the Dutch East India Company (VOC) landed in SA, specifically the Cape of Good Hope and established a refreshment station to be used by the companies ships on voyages between Britain and India.<sup>8</sup>

With the arrival and settling of the Dutch in the Cape came the introduction of their legal system. Roman-Dutch law was entrenched and being applied consistently by the time the British arrived in 1795 fearing that the French Republic would attempt to take over the Cape as part of their expansion, initially through Europe.<sup>9</sup> The British chose not to replace the legal system with English law but rather retain the system in place and introduce various English legal concepts and laws generally. The trust was one such concept that was brought across from English law, initially used by British settlers in terms of wills and deeds of transfer.<sup>10</sup>

There wasn't formal regulation or legislation relating to trusts and the regulation of trusts was left to the courts. The first court case in SA dealing with trusts was *Twentyman*.<sup>11</sup> However in this case as well as a number of subsequent cases the trust was rejected as a legal concept as Roman-Dutch law didn't include such a principle or vehicle/instrument and did not

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<sup>8</sup> Hosten, WJ; Edwards AB; Bosman, F; Church, J; *Introduction to South African Law and Legal Theory* 1995 at p337 (Hosten)

<sup>9</sup> *Ibid* p347

<sup>10</sup> *Braun v Blann and Boha* 1984 (2) SA 850 (A)

<sup>11</sup> *Twentyman v Hewitt* (1833) 1 Menz 156



recognise the main concept of a trust – the separation of legal ownership or rights (vesting in the trustees) and beneficial ownership (vesting in the beneficiaries).<sup>12</sup>

It wasn't until 1915 in *Estate Kemp* that the court had its first opportunity to consider the general concept of English law trusts and their application in SA up until that point. In the case the court confirmed that the English trust could be used in SA and should be recognised. The case did however relate specifically to testamentary trusts.

The extension of the acceptance of English trust law to *inter-vivos* trusts was confirmed in the authoritative case of *Crookes*<sup>13</sup>.

The courts accepted the general principle that a trust is not a legal person, either natural or judicial, but is a vehicle in which assets are held by designated persons for the benefit of a nominated person or persons.

The development of trust law in SA will continue to be heavily influenced by the decisions of the courts even though there is now legislation<sup>14</sup> governing the use of the vehicle.

Although a full analysis of the history of the trust in SA is beyond the objective of this dissertation, for the purpose of this dissertation it suffices that the trust is an entrenched vehicle in South African legislation through case law and legislation. The dissertation proceeds to analyse the specific legislation, from both a structural (including creation, operation, termination) and taxation perspective.

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<sup>12</sup> *Lucas' Trustee v Ismail and Amod* 1905 TS 239

<sup>13</sup> *Crookes v Watson* 1956 (1) SA 277 (A)

<sup>14</sup> Trust Property Control Act, 57 of 1988



### 2.3.2 Legislative developments

#### **Trust Property Control Act, 57 of 1988 (TPCA)**

In 1988 the legislature reacted to the calls for intervention by both taxpayers (who wanted certainty) and SARS and introduced the above mentioned TPCA. The TPCA aimed to regulate the use of trusts in SA.

“Trusts” are defined in the TPCA as:

*The arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed:*

- (a) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or*
- (b) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument, but does not include the case where the property of another person is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965.*

The TPCA is extensive in detailing the various types of trusts, how to form a trust, the parties to a trust, the nature of the various trusts, the rights and obligations of the parties to a trust, contracting with a trust and the compliance requirements of a trust.



The below is a high level outline of the TPCA with sufficient detail to provide readers with the relevant information that will be relied upon in the remaining sections of this dissertation.

### ***Definitions***

Below are the key definitions required for readers of this dissertation:

**'trust'** defined above;

**'trustee'** means any person (including the founder of the trust) who acts as trustee by virtue of an authorisation under section 6 of the TPCA and includes any person whose appointment as trustee is already of force and effect at the commencement of the TPCA;

**'trustee instrument'** means a written agreement or a testamentary writing or a court order according to which a trust is created;

**'trust property'** or **'property'** means movable or immovable property, and includes contingent interests in property, which in accordance with the provisions of a trust instrument are to be administered or disposed of by the trustee

### ***Types of trusts***

Trusts can be distinguished from one another in a variety of ways including who set them up, their legal nature and who the beneficiaries of the trust are. The simplest manner of characterising trusts is by how they are created.

There are four general types of trusts:

1. *Inter-vivos* trust

Created during the life of the founder and governed by the law of contract.



## 2. Testamentary trust

Created on the death of the founder via instruction in their will and is a *sui generis* legal instrument.

## 3. Statute

Created by statute.

## 4. Court order

Created by a court order made by a judge of an official South African court.

The two main types of trusts are the first two, in other words an *inter-vivos* trust and a testamentary trust. Without going into depth the formation of a trust is dependent on the following criteria as set out by Geach<sup>15</sup> based on the TPCA, common law, court decisions and general accepted business principles:

- There must be a trust instrument/deed
- Lodgement of trust instrument with the Master of the High Court
- Founder or testator must have the capacity to act
- Making over or bequest of trust assets
  - This may take the form of a sale or donation. It should be noted that in certain circumstances a donation may give rise to potential income tax or capital gains tax (CGT), for example when the donation is made by and/or to a connected person.

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<sup>15</sup> Geach p37 - 49



- Appointment and authorisation of trustees including the appointment of at least one independent trustee who is not the founder or a beneficiary
- Acceptance of role of trustees
- Intention to create a trust and imposition of an obligation
- Separation of enjoyment from ownership
- The trust must not be treated as anyone's alter ego
- The object of the trust must be lawful
- The trust property must be clearly identified
- The trust object, or purpose, must be well defined and certain
- Beneficiaries must be identifiable
- Upon vesting or distribution of benefits, beneficiaries may elect to accept or repudiate the benefits
- Unnecessarily restrictive clauses or invalid clauses must be avoided
- Trust must have a bank account
- Compliance with the TPCA
- Formalities relating to the making of a will
- Trust minute book
- Trust accounting records and asset register.

The TPCA governs certain aspects of the creation of trusts including the lodgement of trust instruments, the authorisation of trustees, the appointment of trustees by the Master, registration and identification of trust property and access to court.<sup>16</sup>

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<sup>16</sup> Trust Property Control Act 57 of 1988



## Chapter 3: Taxation of trusts

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## Chapter 3: Taxation of trusts

### 3.1 A brief history of the taxation of trusts in SA

As mentioned above, in terms of common law a trust is not a separate legal persona which has independent rights and obligations including taxation obligations. Trusts, at common law, are merely an accumulation of assets and liabilities.

Prior to the amendments to the ITA in 1991 to include a trust as a separate legal person (included in the section 1 definition of 'person') a trust was merely a conduit through which income and expenses flowed. The income was that of the named beneficiaries in the trust.

If the income in the trust did not vest in a beneficiary and therefore no beneficiary had a right to such income and the trust did not distribute such income SARS generally taxed the trustee/s representative taxpayer/s.<sup>17</sup> A representative taxpayer is defined in section 1 of the ITA and generally refers to a person who is responsible for managing a taxpayer's financial or taxation affairs, for example an agent of a natural person or the public officer of a company. It should be noted that section 7(5) of the ITA was introduced to prevent the avoidance of tax by taxpayers transferring assets to a trust but delaying the benefits to beneficiaries.<sup>18</sup> This section and other judicial interventions to combat tax avoidance will be expanded upon in the following sections.

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<sup>17</sup> ITC 288 1933 7 SATC 330

<sup>18</sup> Trusts were introduced into the definition of a 'person' after section 7(5) was introduced.



The above mentioned SARS practice continued until challenged in *Trustees of the Philip Frame Will Trust*<sup>19</sup> in which the court held:

- A trust is not a separate legal person either at common law or under the Income Tax Act.
- The sections of the ITA in relation to representative taxpayers do not apply to trustees of trusts in SA as a representative taxpayer can only be so defined if they act as such in relation to a 'person' as defined in section 1 of the ITA. Since a trust is not a person as defined then the trustees can not be representative taxpayers.
- Therefore, trustees could not be liable for tax on income which had not vested in a beneficiary nor been distributed in general.
- Even though not caught under section 1 of the ITA, income could still be taxed in the hands of a trustee if another section of the ITA was applicable, for example the general anti-avoidance section, section 103, of the ITA may be applicable.

The result of this decision would have been that trust income that vested in the hands of beneficiaries would be taxable in the hands of the beneficiary and income which had not yet vested in the hands of a beneficiary and/or was not distributed at all would not be taxable in the hands of the trustees, the beneficiaries or the trust itself. Therefore, the amount/income may escape taxation in SA generally unless such income fell within the ambit of the section 7, or other, ITA provisions.

This would have created a significant risk for SARS as the precedent set could have been relied upon by taxpayers who would escape taxation by utilising this trust structure. To avoid

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<sup>19</sup> *Commissioner for Inland Revenue v Friedman and others NNO* 1993 (1) SA 353 (A) 55 SATC 39



this, the legislature quickly amended the ITA to include a trust in the definition of a “person” in section 1 of the ITA and introduced section 25B of the ITA. Section 25B, as amended, states:

*(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.*

*(2) Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary.*

*(2A) Where during any year of assessment any resident acquires any vested right to any amount representing capital of any trust which is not a resident, that amount must be included in the income of that resident in that year, if-*

- (a) that capital arose from any receipts and accruals of such trust which would have constituted income if such trust had been a resident, in any previous year of assessment during which that resident had a contingent right to that amount; and*
- (b) that amount has not been subject to tax in the Republic in terms of this Act.*

*(3) Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any amount*



*referred to in subsection (1), must, to the extent to which that amount is under that subsection deemed to be an amount which has accrued to-*

*(a) a beneficiary, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary; and*

*(b) the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that trust.*

*(4) The deduction or allowance contemplated in subsection (3) which is deemed to be made in the determination of the taxable income of a beneficiary of a trust during any year of assessment, shall be limited to so much of the amount deemed to have been received by or accrued to that beneficiary in terms of subsection (1), as is included in the income of that beneficiary during that year of assessment*

*(5) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the amount included in the income of the beneficiary during a year of assessment as contemplated in that subsection-*

*(a) is deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during that year: Provided that the sum of those deductions and allowances shall be limited to the taxable income of that trust during that year of assessment as calculated before allowing any deduction or allowance under this subsection; or*

*(b) where the trust is not subject to tax in the Republic, must be carried forward and be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary by way of amounts referred to in subsection (1) during the immediately succeeding year of assessment.*



*(6) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the sum of the amount included in the income of the beneficiary as contemplated in subsection (4) and the taxable income of the trust as contemplated in subsection (5)(a), must be deemed to be a deduction or allowance for purposes of subsection (3), which may be made in the determination of the taxable income derived by that beneficiary by way of any amount referred to in subsection (1) during the immediately succeeding year of assessment.*

*(7) Subsections (4), (5) and (6) do not apply in respect of any amount which is deemed to have accrued to any beneficiary in terms of subsection (1), where that beneficiary is not subject to tax in the Republic on that amount.*

Together with section 7 of the ITA (additional explanation below), section 25B entrenched in legislation the common law principles relating to trusts as well as closing utilised loopholes.

Today, trusts (both local and foreign) are taxed in SA as separate legal entities to the founder/testator, trustees and/or beneficiaries. A trust is defined in the ITA as:

*"any trust fund consisting of cash or other assets which are administered and controlled by a person acting in a fiduciary capacity, where such person is appointed under a deed of trust or by agreement or under the will of a deceased person."*

As trusts are included in the definition of person they are taxed in terms of section 5 of the ITA which is the standard taxation charging section:

*(1) Subject to the provisions of the Fourth Schedule there shall be paid annually for the benefit of the National Revenue Fund, an income tax (in this Act referred to as the normal tax) in respect of the taxable income received by or accrued to or in favour of-*



(c) *any person (other than a company) during the year of assessment ended the last day of February each year.*

Section 7 of the ITA is a deeming section and deems income to have been received or accrued to certain taxpayers. This dissertation focuses on the recently introduced section 7C. To set the context for the analysis of section 7C the following sections briefly highlight the specific sections of the ITA which are relevant to trusts.

## 3.2 Historical policy developments within trust taxation law in SA

Historically SA's tax policy has been relatively conservative favouring striking a balance between encouraging investment into the country and retaining skilled educated labour and increasing the tax recovered to fund government spending. In the past five years however there has been an increase in aggressive tax policy by the South African legislature. This has been driven by global trends including the increase in transfer pricing legislation and audits, the increase in government spending demands and political agendas.<sup>20</sup>

## 3.3 Davis Tax Committee

### 3.3.1 Introduction<sup>21</sup>

During February 2013 the Minister of Finance, Pravin Gordhan, tabled the 2013/14 budget in which he stated that government would initiate a tax review "*to assess our tax policy*

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<sup>20</sup> Personal view of author based on legislation released by both the South African legislature and international bodies such as the OECD.

<sup>21</sup> <http://www.taxcom.org.za> – accessed June 2017



*framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability”.*

Subsequently, in July 2013, the Minister initiated the tax review by forming a Tax Review Committee (Committee), announcing the members who would make up the committee and setting in place the governing terms of the Committee's existence and mandate.

At the inaugural meeting of the Committee on 25 July 2013 it was decided that the Committee would be known as the Davis Tax Committee (DTC) as it would be headed up by Judge Dennis Davis. Judge Dennis Davis is a serving Judge of the High Court and was well placed to head up the Committee as he was a member of the Commission of Enquiry into the Tax Structure of SA (the Katz Commission).

As mentioned above, the Katz Commission, produced its report in 1995. Since then there had been significant economic changes including the creation of previously unknown businesses such as social media linked enterprises (e.g. Facebook) and other technology based platforms. In addition to new unknown businesses, the tax systems changed functionally and operationally, including “the establishment of an independent tax and customs administration (the South African Revenue Service), the broadening of the tax base, and the lowering of marginal tax rates.”<sup>22</sup>

The following reasons were put forward as motivation for the establishment of the DTC:

1. The rapid pace of globalisation

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<sup>22</sup> <http://www.taxcom.org.za> – accessed June 2017



2. Slow economic growth following the 2008 economic crisis
3. Increasing levels of unemployment
4. Persisting inequalities of wealth and general living conditions
5. Decreasing tax compliance

The DTC would address the tax policy framework in order to address the above mentioned challenges as well as global trends including BEPS which is discussed in more detail in following sections.

It was intended that the DTC would operate on the basis of various sub-committees, each stipulating a date by which submissions should be received from all stakeholders. Based on wide consultation and submissions received, each sub-committee would prepare an interim report for the approval of the Committee as a whole and subsequent submission to the Minister of Finance. The Finance Minister would then determine any further steps required based on the interim report.<sup>23</sup>

### 3.3.2 DTC estate duty report<sup>24</sup>

On 24 August 2016 the DTC released its report on estate duty which was submitted to the Finance Minister for consideration on 28 April 2016.

An interim report had been released for public comment and submissions received were considered and incorporated into the final report. The DTC was advisory in nature and any

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<sup>23</sup> <http://www.taxcom.org.za> – accessed June 2017

<sup>24</sup>

<http://www.taxcom.org.za/docs/20160428%20DTC%20Final%20Report%20on%20Estate%20Duty%20-%20website.pdf> – accessed June 2017



recommendations were purely that, recommendations. The normal process of legislating tax reform would have to be followed including the review by Parliament.

The report makes, inter alia, the following recommendations in relation to trusts:

- **“Statistical analysis**

- Statistics obtained from SARS are indicative of a very prevalent use of trusts in SA today. The disparity in the number of registered trusts, compared to the number of tax returns received, is cause for concern and warrants substantial further investigation of trusts by SARS.
- The fact that 87,8 per cent (88 344 out of 100 590) of *prima facie* compliant trusts are apparently *inter-vivos* trust arrangements reflects the need for a comprehensive analysis of each trust to ensure that the trust is compliant with the ITA and Estate Duty Act, 1955 (EDA).
- The very fundamentals of the legislation should also be considered.

- **Estate duty and trusts**

- NT (*National Treasury*) should consider the possibility of extending the provisions of section 3(3)(d) of the EDA to include deeming provisions that identify “deemed control” of a trust through a loan account between a trust and a “connected person(s)”, where the loan is not subject to interest or is subject to interest at below the official rate. In these circumstances, the loan provides the lender with de facto control over the trust.
- All trust arrangements should be examined by SARS on registration of trust instruments and upon transfer of assets into trusts. This should reduce aggressive tax planning and, at the same time, provide a level of assurance to taxpayers that their affairs are indeed in order.



- **Capital Transfer Tax**
  - Further investigation be conducted into the implementation of wealth taxes in SA. This will be addressed in a separate report of the DTC during 2016.
- **Income Tax: Vested trusts**
  - Donors and beneficiaries of all vested trust arrangements should be subject to stricter disclosure requirements and enforcement measures.
  - SARS should develop risk-profiling analysis to identify and examine trust arrangements.
  - Estate duty assessment procedures of SARS should concentrate on the examination of any trusts in which the deceased may have enjoyed a vested interest in order to ensure that all income and capital has been brought into account for both income tax and estate duty purposes.
- **Income Tax: Discretionary Trusts**
  - Only where a trust deed confers upon its beneficiaries an indisputable and irrevocable vested right to both the capital and income of a trust, should the income, both capital and revenue, be taxed in the hands of the beneficiary.
  - In all other cases:
    - Revenue income must be taxed in the trust in accordance with the definition of “gross income” contained in section 1 of the ITA.
    - Capital income, generated while assets are held in trust on anything other than a vested basis, must be taxed within the trust up to the time of vesting or disposal as defined in paragraph 11 of the Eighth Schedule to the ITA.



- **Trust tax rates and CGT inclusion rates**
  - The flat rate of tax applied to trusts should be retained at its current level and be subject to adjustment in line with changes in the maximum personal income tax rate.
- **Foreign Discretionary Trusts**
  - The comprehensive examination of foreign trust arrangements should not be confined to the application of the ITA when vesting or distribution occurs. SARS should also examine the substance of arrangements prior to vesting or distribution. Information sharing between tax authorities may well be the starting point for such investigations.
  - SARS should establish a separate investigations unit to thoroughly and comprehensively examine foreign trust arrangements. Where disclosure deficiencies are detected, the penalty provisions of the Tax Administration Act, 2011 (TAA) should be rigidly applied.
- **Offshore retirement funds**
  - These arrangements should be further investigated by SARS.”

The recommendations in relation to the conferment of benefits through vested rights were taken into consideration and relevant corrective measures were recommended in the form of the amendment to ITA sections and/or the introduction of new sections.<sup>25</sup> Section 7C is the result of one such recommendation.

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<sup>25</sup> Reports including recommendations by the DTC include: The Macro Analysis Final Report, the SME Final Report, the Estate Duty Final Report, the Carbon Tax Report and the interim VAT Report and Mining Report.



### 3.4 Recent policy developments within trust taxation law in SA

On 25 October 2017 Finance Minister Malusi Gigaba delivered the Medium Term Budget Policy Statement (MTBPS). The available documentation that accompanied the statement was the “Revenue trends and tax policy” document<sup>26</sup>. The document highlights the R50.8 billion revenue shortfall expected by SARS during the 2016/2017 financial years. This is the largest shortfall relative to budgeted estimates since 2009/2010. The summary states:

*“The tax proposals aim to raise the necessary revenue in a progressive manner to reinforce the social compact and address excessive levels of inequality. The potential effects on economic growth will be monitored. Government remains committed to maintaining a progressive, stable and transparent tax system that improves tax morality, and that is supported by a professional and effective tax administration.”*

The most recent Tax Law Amendment Bill (TLAB2017), published on 13 October 2017, and the Rates and Monetary Amounts and Amendment of Revenue Laws Bill, dated 22 February 2017, include the following proposals:

1. A new top personal income tax bracket of 45% for taxable incomes above R1.5 million;
2. Limited relief for bracket creep;
3. An increase in the dividend withholding tax rate to 20%; and

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<sup>26</sup> <http://www.treasury.gov.za/documents/national%20budget/2017/review/Chapter%204.pdf> – accessed June 2017



4. A 30 cent per litre increase in the general fuel levy and a 9 cent per litre increase in the Road Accident Fund fuel levy.

Not surprisingly an increase in the VAT rate was not proposed as it is seen as a tax which hits the poor the hardest. Given the upcoming elections in 2019 it was not expected to be changed, even though there is substantial evidence from other jurisdictions that it is an effective way to collect additional tax in difficult economic times. Although not solely in relation to trusts, not increasing the VAT rate provides insight into why additional revenue from other sources, including trusts, has been tabled. The inclusion of section 7C, while having an underlying rationale (i.e. the prevention of tax evasion through interest free loans) does also fulfil a secondary function - generating additional revenue through tax collection.

Although trusts were not specifically referred to in the MTBPS, as mentioned above, section 7C of the Income Tax Act was introduced on 19 January 2017 by the Taxation Laws Amendment Act No. 15, 2017 and became effective as from 1 March 2017. Seen as a vehicle of the wealthy, trusts have historically been, and will continue to be, targeted by politicians as a campaigning tool and government (SARS) for potential additional tax collection. This assumes that those using trusts do so for tax evasion reasons which is not always the case.

### 3.4.1 Section 7C of the ITA

#### 3.4.1.1 Introduction

On 24 February 2016, Finance Minister, Mr Pravin Gordhan, delivered the national budget for the country for the following year. Accompanying his speech was the 2016 Budget



Review document in which interest free loans to trusts were challenged. This was, however, not the first time interest free loans were mentioned in a budget speech.

The 2016 Budget Review document stated:

*"An important role of the tax system is to reduce inequality. Some taxpayers use trusts to avoid paying estate duty and donations tax. For example, if the founder of a trust sells his or her assets to the trust, and grants the trust an interest-free loan as payment, donations tax is not triggered and the assets are not included in his or her estate at death. To limit taxpayers' ability to transfer wealth without being taxed, government proposes to ensure that the assets transferred through a loan to a trust are included in the estate of the founder at death, and to categorise interest free loans to trusts as donations. Further measures to limit the use of discretionary trusts for income-splitting and other tax benefits will also be considered."<sup>27</sup>*

Consequently, the draft Taxation Laws Amendment Bill, 2016 was published on 8 July 2016.

It inserted section 7C into the ITA and set out certain provisions governing interest-free or low-interest loans made by a taxpayer to a trust.<sup>28</sup>

The final section 7C was introduced to the ITA by the Taxation Laws Amendment Act No. 15, 2017, which was promulgated on 19 January 2017.<sup>29</sup>

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<sup>27</sup> <http://www.treasury.gov.za/documents/national%20budget/2016/review/FullReview.pdf> – accessed June 2017

<sup>28</sup>

<http://www.treasury.gov.za/public%20comments/TLAB%20and%20TALAB%202016%20Draft/2016%20Draft%20Taxation%20Laws%20Amendment%20Bill.pdf>

<sup>29</sup> <http://www.sars.gov.za/AllDocs/LegalDoclib/AmendActs/LAPD-LPrim-AA-2017-04%20-%20Tax%20Administration%20Laws%20Amendment%20Act%202016%20of%202016%20GG%2040563.pdf> – accessed June 2017



Section 7C came into operation on 1 March 2017 and applies in respect of years of assessment commencing on or after that date.

### 3.4.1.2 Critical analysis of section 7C of the ITA

Section 7C of the ITA, which is set out in full in Annexure A, provides for the taxation of deemed donations made to a trust by a connected person.

In brief, where a connected person transfers assets to a trust creating an interest free or below market related interest rate (as defined) loan to the trust the amount of foregone market related interest is deemed to be a donation from the connected person to the trust.

It should be noted that the National Treasury published the Draft Taxation Laws Amendment Bill 2017 (“Draft TLAB”) on 19 July 2017, which proposes amendments to section 7C. These proposed amendments will be discussed in detail later.

#### **Applicability**

Section 7C of the ITA applies to any loan, advance or credit provided to a trust directly or indirectly by a natural person or a company in relation to whom that natural person or the company is a connected person as defined by section 1 of the ITA.

A connected person is defined in section 1 of the ITA as:

*“a) in relation to a natural person—*

*i) any relative; and*

*ii) any trust (other than a portfolio of a collective investment scheme) of which such natural person or such relative is a beneficiary;*



*b) in relation to a trust (other than a portfolio of a collective investment scheme)—*

*i) any beneficiary of such trust; and*

*ii) any connected person in relation to such beneficiary;*

*bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme), any other person who is a connected person in relation to such trust;*

*c) in relation to a member of any partnership or foreign partnership—*

*i) any other member; and*

*ii) any connected person in relation to any member of such partnership or foreign partnership;*

...

### **Limitations and exclusions**

Section 7C(2) provides that no deduction, loss, allowance or capital loss may be claimed by a loan provider (person or company) in respect of loans described in section 7C(1) of the ITA.

A number of trusts, for example public benefit organisations, are excluded from the application of section 7C. There are also other exclusions for example if the loan, advance or credit constitutes an “affected transaction” as defined in section 31(1), which covers transfer pricing rules. Further analysis of the relationship between sections 7C and 31 is contained in the following sections.



## Deemed donation

Section 7C(3) provides that if a trust received a section 7C(1) loan at no or a low interest rate then an amount equal to the difference between the interest rate charged (which may be zero if interest free) and the official rate of interest, which is deemed to be the market rate, must be treated as a donation to the trust by the loan provider for that year of assessment.

## Multiple loan providers

Section 7C(4) provides that if a loan, credit or advance was provided to a trust by more than one company that is a connected person in relation to that company, an amount must be treated as a donation by the company in its respective shareholding ratio.

## Vesting rights

On 15 December 2016 SARS published an explanatory memorandum providing examples and additional guidance as to when the proposed rules (enacted as section 7C) would, and would not, be applicable. The memorandum includes the following valuable guidance<sup>30</sup>:

*“The proposed rules will apply only in respect of loans advanced or provided by a natural person or, at that person’s instance, by a connected company. An amount that is vested irrevocably by a trustee in a trust beneficiary and that is used or administered for the benefit of that beneficiary without distributing or paying it to that beneficiary will not qualify as a loan or credit provided by that beneficiary to that trust if*

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<sup>30</sup> <http://www.sars.gov.za/AllDocs/LegalDoclib/ExpIMemo/LAPD-LPrep-EM-2016-02%20-%20EM%20on%20the%20Taxation%20Laws%20Amendment%20Bill%2017B%20of%202016%2015%20December%202016.pdf> – accessed June 2017



- *the vested amount may in terms of the trust deed governing that trust not be distributed to that beneficiary, e.g. before that beneficiary reaches a specific age; or*
- *that trustee has the sole discretion in terms of that trust deed regarding the timing of and the extent of any distribution to that beneficiary of such vested amount.*

*An amount vested by a trust in a trust beneficiary that is not distributed to that beneficiary will, however, qualify as a loan or credit provided by that beneficiary to that trust if that non-distribution results from an election exercised by that beneficiary or a request by that beneficiary that the amount not be distributed or paid over, e.g. if the beneficiary has reached the age at which a vested amount must be paid over or distributed to him or her and*

- *the trustee accedes to a request by that beneficiary that this not be done;*  
*or*
- *the beneficiary enters into an agreement with the trustee in terms of which the amount may be retained in the trust.*

Additionally, section 7C(5)(b) addresses the vested interests of beneficiaries and both highlight the need to specifically deal with vested rights in the trust deed upon its creation or thereafter as an amendment to the instrument. The risk a beneficiary may face is that any vested amount that is not distributed may be seen as a deemed loan to the trust and should interest at the official rate not be charged (accrued) such difference may be seen as a deemed donation, subject to donations tax. Although the Explanatory Memorandum indicates that this will not be a deemed donation, the legislation is unclear and therefore there is a potential risk in relation to misinterpretation and misapplication.



### 3.4.1.3 Section 31 of the ITA

#### 3.4.1.3.1 Introduction

Section 31 of the ITA is specifically referenced as an applicable exclusion in section 7C of the ITA. Section 31 is the provision within the ITA that governs South Africa's transfer pricing regime. If section 31(1) of the ITA applies, section 7C(2) and (3) do not apply as confirmed in SARS' explanatory memorandum<sup>31</sup>. Section 31 is explored in further detail below.

Section 31 of the ITA states:

*(1) For the purposes of this section –*

**'affected transaction'** means any transaction, operation, scheme, agreement or understanding where –

*(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both-*

*(i) (aa) a person that is a resident; and*

*(bb) any other person that is not a resident;*

*(ii) (aa) a person that is not a resident; and*

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<sup>31</sup> <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2016-02%20-%20EM%20on%20the%20Taxation%20Laws%20Amendment%20Bill%2017B%20of%202016%2015%20December%202016.pdf> – accessed June 2017



*(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;*

*(iii) (aa) a person that is a resident; and*

*(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or*

*(iv) (aa) a person that is not a resident; and*

*(bb) any other person that is a controlled foreign company in relation to any resident,*

*and those persons are connected persons in relation to one another; and*

*(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length.*

### **Purpose of section 31<sup>32</sup>**

To understand the importance and purpose of section 31 of the ITA it is important to understand the underlying concept of transfer pricing. In its most basic form transfer pricing describes the process by which connected persons price transactions (whether tangible, intangible, financial or services) between one another.

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<sup>32</sup> <http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-PrN-2012-11%20-%20Income%20Tax%20Practice%20Note%207%20of%201999.pdf> – accessed June 2017



Multinational enterprises (MNEs) by their very nature operate to different extents in various countries. The in-country operation may be a distributor, manufacturer, service provider or entrepreneur. Additionally, this operation may transact with other group entities. An example may be that an MNE is headquartered in London, England, it has a mine in SA and various other African countries and has an office (entity) in Mauritius. The entity in SA is responsible for the extraction of gold from the ground. It has prospected and attained all required government licences to mine. SA has a 28% corporate tax rate and in its simplest terms one would expect that the South African entity would pay tax on the revenue from the sale of the gold less allowable expenses and other allowances as per the ITA. One allowable expense or deduction is service fees, including management fees. If the South African entity sells the gold to a foreign connected person for less than an “arm’s length”<sup>33</sup> price or pays more to for example the Mauritian entity for management services the taxable amount in SA may be less than it would have otherwise have been had all the parties to the transaction not have been connected. The net result being that the correct amount of tax would not be paid in the country in which it should have been.

Transfer pricing rules and legislation are aimed at ensuring that the correct amount of tax is paid in the correct county.

#### 3.4.1.3.2                      Applicability to trusts

As previously discussed a trust is included as a connected person as defined by section 1 of the ITA.

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<sup>33</sup> Arm’s length can simply be defined as the terms and conditions (including price) that would have been agreed to by independent third parties.



Additionally, practice note 7 (PN7) defines a connected person in relation to a trust:

*(i) any beneficiary of such trust, i.e. any person named as a beneficiary in the trust deed or letter of wishes, or any other person in favour of whom the trustee of the trust exercises the trustee's discretion; and*

*(ii) any connected person in relation to such beneficiary, for example any of the beneficiary's relatives and any trust of which a relative may be a beneficiary. A trust and connected persons in relation to the beneficiaries of the trust, are connected persons.*

Therefore, in summary, transfer pricing rules apply to trusts in SA which has transactions with related parties (connected persons) which may be companies, partnerships, trusts or even individuals in certain circumstances.

The implication is that any **cross border** transaction between a trust and a connected person must be at arm's length. Terms and conditions, including interest charged on a loan, must be as if between two independent third parties. Should such a transaction not be at arm's length SARS may adjust the transaction to be arm's length. This may result in additional revenue and profits that will be taxed at the corporate rate. In addition interest and penalties would be payable. Finally, this discussed primary adjustment would result in a secondary adjustment which deems the adjusted amount to be a dividend provided by the taxpayer and dividends tax will be applicable.

### 3.4.1.3.3 Interaction between section 7C, 31, 7(5), 7(8)

#### Section 31



As stated above section 31 of the ITA governs cross border connected person transactions, including those between a trust and a connected person. If SARS was to apply section 7C of the ITA to a particular transaction between a trust and a foreign connected person then there may potentially be double taxation when section 31 is also applied. It is for this reason that section 7C(5)(e) was included in the ITA. It states:

*(5) Subsections (2) and (3) do not apply in respect of any amount owing by a trust during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) if—*

*(e) that loan, advance or credit constitutes an affected transaction as defined in section 31(1) that is subject to the provisions of that section;*

Therefore, if section 31(1) of the ITA applies, section 7C(2) and (3) do not apply as confirmed in SARS' explanatory memorandum<sup>34</sup>. The inclusion of this subsection effectively excludes the application of section 7C to cross border interest free (or below arm's length interest rate) loans to trusts. These will be dealt with by the application of section 31 of the ITA.<sup>35</sup>

One potential oversight in the current wording of section 7C may be the limitation of the exclusion in 7C(5)(e) to only loans that meet the requirements of subsection (1) of section 31. Subsection (1) discusses transfer pricing adjustments in relation to affected transactions which are defined as transactions between connected persons that are not at arm's length. In other words, in relation to loans, transactions with terms and conditions which are not at

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<sup>34</sup> <http://www.sars.gov.za/AllDocs/LegalDoclib/ExplMemo/LAPD-LPrep-EM-2016-02%20-%20EM%20on%20the%20Taxation%20Laws%20Amendment%20Bill%2017B%20of%202016%2015%20December%202016.pdf> – accessed June 2017

<sup>35</sup> Section 7(5) of the ITA will be dealt with below.



arm's length. Therefore, as stated above, loans between a natural person and a trust with terms and conditions which are dissimilar to those between independent persons would not be at arm's length and would therefore fall under section 31(1) and be excluded from section 7C.

However, loans between a natural person and a trust with terms and conditions which are similar to those between independent persons would be arm's length, would not be affected transactions, would not fall under section 31(1) and section 7C would apply. This would be true even when the arm's length interest rate, which may be determined through a benchmarking exercise, is lower than the official rate of interest. In this case section 7C would apply even though a taxpayer has performed an independent exercise to support the arm's length interest rate. This clearly would only be in relation to cross border transactions between a South African natural person and a foreign trust as SA does not have domestic transfer pricing, unlike countries such as Zimbabwe. Domestic transfer pricing includes transactions between connected / related entities within the same country. South Africa does not have domestic transfer pricing rules. From the 2016 explanatory memorandum it is submitted that the rationale for the exception to section 7C when section 31(1) is applicable was to avoid overlap between the application of both sections when the loan is subject to section 31's transfer pricing rules.

*A potential solution may be to amend the wording "subject to the provisions of that section" contained in section 7C(5)(e) to ensure that "loans with arm's length interest rates" are excluded under section 7C(5)(e).*



## Section 7(5) and 7(8)

Section 7 of the ITA is made up of a number of subsections which deem income to have accrued or to have been accrued to a taxpayer, whether that taxpayer is the donor, trustee or beneficiary.

Below are extracts of two subsections of section 7 of the ITA that have specific consequences in relation to section 31 of the ITA as well as raising questions in relation to section 7C of the ITA.

*7. When income is deemed to have accrued or to have been received*

*(5) If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person.*

*(8) (a) Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident*



*so much of that amount as is attributable to that donation, settlement or other disposition.*

*(b) So much of any expenditure, allowance or loss incurred by the person contemplated in paragraph (a) as does not exceed the amount included in the income of the resident in terms of that paragraph and which would be allowable as a deduction under this Act in the determination of the taxable income derived from that amount had that person been a resident, is deemed to be an expenditure, allowance or loss incurred by that resident for purposes of the determination of the taxable income of that resident from that amount.*

Both sections 7(5) and 7(8) contain a key starting phrase: “donation, settlement or other disposition”. This term is not defined in the ITA, however the courts have set out a number of guiding principles in this regard:

- The disposal must be made wholly or in part gratuitously out of the liberality or generosity;
- If some consideration is provided for but there is also an appreciable element of gratuitousness, the income resulting from the disposal within the trust may be apportioned. If an apportionment is not possible the whole amount of income must be deemed to be that of the donor.<sup>36</sup>

In relation to interest free loans (the subject of section 7C) it has been held that a loan which is interest free is regarded as a continuing loan, especially if the asset sold into the trust on

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<sup>36</sup> *Ovenstone v SIR* 1980 (2) SA 721 (A), 42 SATC 55.



loan account is income producing.<sup>37</sup> The following two criteria must be met in order for section 7(5) to apply:

1. The donation, settlement or other disposition must be subject to a stipulation or condition; and
2. The stipulation or condition must have the effect that one or more beneficiaries will not receive income until the happening of a future event.

It is submitted therefore that should no stipulation or condition exist, or exist but not affect the income rights of the beneficiaries to the trust then section 7(5) would not apply. It is further submitted that whether this is the case or not, section 7C may nevertheless still be applicable.

In a scenario where no income is produced by the asset sold to a trust, there may be a deemed donation, however since no income is produced section 7(5) would not apply. Section 7C (not cross border) or 31 (cross border) may nevertheless still be applicable.

Thus, where income is produced by the asset sold to a trust sections 7(5) and 7C may apply simultaneously. For example, if a person (Mr X) sells a house to a trust (to which he is a connected person, as defined) on loan account (interest free) and such house is subsequently rented to tenants and such income is payable to the beneficiaries subject to a condition which has not yet been fulfilled, such rental income which arises in consequence of the donation, settlement or other disposition, will be deemed to be that of Mr X until the fulfilment of that condition.<sup>38</sup> As the trust incurs no interest on the loan, such amount which

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<sup>37</sup> *Ibid*

<sup>38</sup> The attribution would be limited to the interest foregone – Commissioner for South African Revenue Service v Woulidge 2000 (1) SA 600 (C).



would otherwise have been incurred had interest at the official rate been charged will be treated as a donation made to that trust by Mr X.

Section 7(5) is taxing a portion of the rental income attributable to the 'donation' while 7C is taxing the interest which would otherwise have been earned had interest, at the official rate, been charged. Therefore, no double taxation exists.

### **Section 7(8)<sup>39</sup>**

Both sections 7(5) and 7(8) of the ITA apply to a donation, settlement or other disposition, however based on the amendment of section 7(8) in 2004 changing the word 'income' to 'amount' while not changing the same word in 7(5) it is clear that legislature intends 7(5) to apply only to South African domestic trusts while 7(8) is applicable to foreign trusts which are not tax resident in SA.<sup>40</sup> Interestingly, section 7C also refers to an "amount" and therefore following similar reasoning to the above may also apply to loans, advances or credits made to a foreign trust, not only South African domestic trusts.

The main elements of section 7(8) are:

- There must be a settlement, donation or other disposition made by a South African resident;
- An amount must have been received by or accrued to a person who is not a resident by reason of or in consequence of the settlement, donation or other disposition; and

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<sup>39</sup> [https://www.saica.co.za/integritax/2001\\_March\\_Special\\_issue/6\\_1\\_Deemed\\_Income.htm](https://www.saica.co.za/integritax/2001_March_Special_issue/6_1_Deemed_Income.htm) – accessed June 2017

<sup>40</sup> Honniball p91



- The amount would have constituted income had that person been a tax resident.<sup>41</sup>

If these are met, an amount attributable to the settlement, donation or other disposition shall be included in the income of the South African resident. This amount would be equal to the portion of the income arising as a consequence of the settlement, donation or other disposition which would have constituted income had the recipient (here the trust) been a South African tax resident.

As discussed in full in section 3.4.1 section 7C relates to the transfer of assets which create loans, particularly interest free or less than the official rate loans. Where a taxpayer advances funds, or other assets, to a trust creating a loan with no or low interest the difference will attract donations tax in the hands of the taxpayer. If the trust is a foreign trust and the advanced funds generate income in that foreign trust and the income is the type which would have attracted tax had it been in the hands of a South African resident then the South African taxpayer would be liable for the donations tax on the deemed donated amount as well as income tax on the income received by the foreign person by reason of, or in consequence, of the advanced funds.

Finally, it is submitted that in a scenario where section 31 and s7(8) may be applicable, section 31 is likely to take precedence. As SARS will deem interest on the cross border loan SARS has indicated that it would not treat the loan as a donation, settlement or other disposition for purposes of section 7(8). This is an area in which further research may be performed.

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<sup>41</sup> Honniball p95



### Tax Law Amendment Bill 2017 (TLAB2017)

Following the introduction of section 7C a number of schemes were devised to circumvent the application of the section. One such example is where a trust beneficiary makes a loan to a company in which the trust owns more than 20%. In this scenario section 7C in its current form could potentially be circumvented.

To close this potential loophole the TLAB2017 proposes changing the bolded portion of section 7C(1) below:

*(1) This section applies in respect of any loan, advance or credit that—*

*(a) a natural person; or*

*(b) at the instance of that person, a company in relation to which that person is a connected person in terms of paragraph (d)(iv) of the definition of connected person,*

*directly or indirectly provides to a trust in relation to which that person or company, or any person that is a connected person in relation to that person or company, is a connected person.*

to the following:

*“directly or indirectly provides to*

*(i) a trust in relation to which—*

*(aa) that person or company, or*

*(bb) any person that is a connected person in relation to the person or company referred to in item (aa),*



*is a connected person; or*

*(ii) a company if at least 20 per cent of—*

*(aa) the equity shares in that company are held, directly or*

*indirectly; or*

*(bb) the voting rights in that company can be exercised,*

*by the trust referred to in subparagraph (i) or by a beneficiary of*

*that trust.”;*

The proposed amendments to section 7C(1) result in the section applying:

- where a natural person or company directly or indirectly provides a loan, advance or credit to another company
- the company receiving the loan is one in which at least 20 per cent of the equity shares or voting rights may be exercised by a trust *or a beneficiary of that trust*
- the trust must be a connected person in relation to the natural person or company that provided the loan, advance or credit. *(my emphasis)*

One potentially unforeseen consequence is that the ambit of the amended section 7C may now be wider than anticipated and may unintentionally apply to normal business loans by including the reference to beneficiaries of trusts that hold 20% of the equity shares or voting rights in relation to the natural person or company providing the loan, advance or credit.

The effect is that even where there is no shareholding link between the company and the trust a loan may be within the ambit of the section, as currently worded, if a natural person is a beneficiary of a trust and advances a loan (at no interest or an interest at less than the



official rate) to a company in which the natural person holds at least 20% of the equity shares or voting rights.

Currently, it would seem that removing the words “or by a beneficiary of that trust” from the updated section in the TLAB would remedy this unintended consequence without removing the ability of SARS to tax the alleged misdemeanour covered by section 7C. Further research into potential unforeseen circumstances that may affect this ability of SARS should be performed.

#### 3.4.1.3.4 OECD BEPS considerations<sup>42</sup>

Finally, the latest Organisation of Economic Co-Operation and Development (OECD) BEPS publications will be considered in their applicability to section 7C.

*“Base erosion and profit shifting (BEPS) refers to tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations. Under the inclusive framework, over 100 countries and jurisdictions are collaborating to implement the BEPS measures and tackle BEPS.”<sup>43</sup>*

There are 15 action reports which form part of the BEPS publications. These have been drafted after significant consultation, draft publication, comment (including public comment), redrafting and finalisation. The final reports are aimed at equipping governments with the domestic and international tools required to tackle BEPS.

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<sup>42</sup> <http://www.oecd.org/tax/beps.htm> – accessed June 2017

<sup>43</sup> *Ibid*



*“Countries now have the tools to ensure that profits are taxed where economic activities generating the profits are performed and where value is created. These tools also give businesses greater certainty by reducing disputes over the application of international tax rules and standardising compliance requirements.”<sup>44</sup>*

The final reports as well as the domestic legislation that has been, and will be, put in place to give effect to the reports provide further weight to a growing wave of international scrutiny and action in the prohibition and penalising of illegal and immoral financial and taxation behaviours by both individuals and corporations.

As discussed above transactions that fall within the ambit of section 31 are specifically excluded from section 7C's ambit, indicating the importance the South African legislature is placing on section 31 and, by implication, the OECD Guidelines to cover the base erosion potential of interest free loans to foreign trusts.

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<sup>44</sup> *Ibid*



## Chapter 4: Conclusion and suggestions for further research

The introduction of section 7C of the ITA is directly in line with the existing section 7 as well as international trends including the BEPS final reports. As globalisation accelerates and data becomes more readily available to both developed and developing economies the transparency of structures will become more evident and the previously utilised loopholes will close. Additionally, the current economic downturn in SA, and globally, is likely to result in more aggressive revenue authorities. Taxpayers will have to ensure that they receive appropriate advice and that tax is considered at the outset of structure development opposed to being an afterthought following the commercial agendas.

As discussed above, there is currently room for the application of sections 7C, 7(5) and 7(8) simultaneously in specific circumstances which may result in the application of both donations and income tax. The question remains as to whether the application of these section is fair and/or correct. I think it is probably difficult to argue that it is not at this stage.

Additionally, in relation to the cross border element, as discussed section 31 takes precedence over section 7C. In a number of years, following SARS application and possible court cases, an analysis of its application in relation to the wider BEPS initiative would make for an interesting research paper.

Finally, it is submitted that the question raised by this dissertation – does section 7C of the ITA achieve its stated objective (the prevention of tax evasion through interest free loans) has been answered in the affirmative.



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# Annexure A: Relevant legislation

## Income Tax Act, 58 of 1962

### **Section 1**

*"Connected person"*

*a) in relation to a natural person—*

*i) any relative; and*

*ii) any trust (other than a portfolio of a collective investment scheme) of which such natural person or such relative is a beneficiary;*

*b) in relation to a trust (other than a portfolio of a collective investment scheme)—*

*i) any beneficiary of such trust; and*

*ii) any connected person in relation to such beneficiary;*

*bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme), any other person who is a connected person in relation to such trust;*

*c) in relation to a member of any partnership or foreign partnership—*

*i) any other member; and*

*ii) any connected person in relation to any member of such partnership or foreign partnership;*

*d) in relation to a company—*



*i) any other company that would be part of the same group of companies as that company if the expression 'at least 70 per cent of the equity shares in' in paragraphs (a) and (b) of the definition of 'group of companies' in this section were replaced by the expression 'more than 50 per cent of the equity shares or voting rights in';*

*ii) [Subparagraph (ii) deleted by Revenue Laws Amendment Act, 2006 (Act No. 20 of 2006)];*

*iii) [Subparagraph (iii) deleted by Revenue Laws Amendment Act, 2006 (Act No. 20 of 2006)];*

*iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of—*

*aa) the equity shares in the company; or*

*bb) the voting rights in the company;*

*v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in that company;*

*vA) any other company if such other company is managed or controlled by—*

*aa) any person who or which is a connected person in relation to such company;*

*or*

*bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and*

*vi) where such company is a close corporation—*



aa) any member;

bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme which is a connected person in relation to such member; and

cc) any other close corporation or company which is a connected person in relation to—

i) any member contemplated in item (aa); or

ii) the relative or trust contemplated in item (bb); and

e) in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person;

*Provided that for the purposes of this definition, a company includes a portfolio of a collective investment scheme in securities”*

### **Section 7C**

*(1) This section applies in respect of any loan, advance or credit that—*

*(a) a natural person; or*

*(b) at the instance of that person, a company in relation to which that person is a connected person in terms of paragraph (d)(iv) of the definition of connected person,*

*directly or indirectly provides to a trust in relation to which that person or company, or any person that is a connected person in relation to that person or company, is a connected person.*

*(2) No deduction, loss, allowance or capital loss may be claimed in respect of—*

*(a) a disposal, including by way of a reduction or waiver; or*



*(b) the failure, wholly or partly, of a claim for the payment,*

*of any amount owing in respect of a loan, advance or credit referred to in subsection (1).*

*(3) If a trust incurs—*

*(a) no interest in respect of a loan, advance or credit referred to in subsection (1);*

*or*

*(b) interest at a rate lower than the official rate of interest as defined in paragraph 1 of the Seventh Schedule,*

*an amount equal to the difference between the amount incurred by that trust, during a year of assessment as interest in respect of that loan, advance or credit and the amount that would have been incurred by that trust at the official rate of interest must, for purposes of Part V of Chapter II, be treated as a donation made to that trust by the person referred to in subsection (1)(a) on the last day of that year of assessment of that trust.*

*(4) If a loan, advance or credit was provided by a company to a trust at the instance of more than one person that is a connected person in relation to that company as referred to in paragraph (b) of subsection (1), each of those persons must be treated as having donated, to that trust, the part of that amount that bears to that amount the same ratio as the equity shares or voting rights in that company that were held by that person during that year of assessment bears to the equity shares or voting rights in that company held in aggregate by those persons during that year of assessment.*



*(5) Subsections (2) and (3) do not apply in respect of any amount owing by a trust during a year of assessment in respect of a loan, advance or credit referred to in subsection (1) if—*

*(a) that trust is a public benefit organisation approved by the Commissioner in terms of section 30(3) or a small business funding entity approved by the Commissioner in terms of section 30C;*

*(b) that loan, advance or credit was provided to that trust by a person by reason of or in return for a vested interest held by that person in the receipts and accruals and assets of that trust and—*

*(i) the beneficiaries of that trust hold, in aggregate, a vested interest in all the receipts and accruals and assets of that trust;*

*(ii) no beneficiary of that trust can, in terms of the trust deed governing that trust, hold or acquire an interest in that trust other than a vested interest in the receipts and accruals and assets of that trust;*

*(iii) the vested interest of each beneficiary of that trust is determined solely with reference and in proportion to the assets, services or funding contributed by that beneficiary to that trust; and*

*(iv) none of the vested interests held by the beneficiaries of that trust is subject to a discretionary power conferred on any person in terms of which that interest can be varied or revoked;*

*(c) that trust is a special trust as defined in paragraph (a) of the definition of a special trust;*

*(d) that trust used that loan, advance or credit wholly or partly for purposes of funding the acquisition of an asset and—*



*(i) the person referred to in subsection (1)(a) or the spouse of that person used that asset as a primary residence as contemplated in paragraph (b) of the definition of 'primary residence' in paragraph 44 of the Eighth Schedule throughout that year of assessment; and*

*(ii) the amount owed relates to the part of that loan, advance or credit that funded the acquisition of that asset;*

*(e) that loan, advance or credit constitutes an affected transaction as defined in section 31(1) that is subject to the provisions of that section;*

*(f) that loan, advance or credit was provided to that trust in terms of an arrangement that would have qualified as a sharia compliant financing arrangement as contemplated in section 24JA, had that trust been a bank as defined in that section; or*

*(g) that loan, advance or credit is subject to the provisions of section 64E(4).*

#### **Section 7(5)**

*(5) If any person has made any donation, settlement or other disposition which is subject to a stipulation or condition, whether made or imposed by such person or anybody else, to the effect that the beneficiaries thereof or some of them shall not receive the income or some portion of the income thereunder until the happening of some event, whether fixed or contingent, so much of any income as would, but for such stipulation or condition, in consequence of the donation, settlement or other disposition be received by or accrue to or in favour of the beneficiaries, shall, until the happening of that event or the death of that person, whichever first takes place, be deemed to be the income of that person.*

#### **Section 7(8)**



*(8) (a) Where by reason of or in consequence of any donation, settlement or other disposition (other than a donation, settlement or other disposition to an entity which is not a resident and which is similar to a public benefit organisation contemplated in section 30) made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident, there shall be included in the income of that resident so much of that amount as is attributable to that donation, settlement or other disposition.*

*(b) So much of any expenditure, allowance or loss incurred by the person contemplated in paragraph (a) as does not exceed the amount included in the income of the resident in terms of that paragraph and which would be allowable as a deduction under this Act in the determination of the taxable income derived from that amount had that person been a resident, is deemed to be an expenditure, allowance or loss incurred by that resident for purposes of the determination of the taxable income of that resident from that amount.*

### **Section 25B**

*(1) Any amount received by or accrued to or in favour of any person during any year of assessment in his or her capacity as the trustee of a trust, shall, subject to the provisions of section 7, to the extent to which that amount has been derived for the immediate or future benefit of any ascertained beneficiary who has a vested right to that amount during that year, be deemed to be an amount which has accrued to that beneficiary, and to the extent to which that amount is not so derived, be deemed to be an amount which has accrued to that trust.*

*(2) Where a beneficiary has acquired a vested right to any amount referred to in subsection (1) in consequence of the exercise by the trustee of a discretion vested*



*in him or her in terms of the relevant deed of trust, agreement or will of a deceased person, that amount shall for the purposes of that subsection be deemed to have been derived for the benefit of that beneficiary.*

*(2A) Where during any year of assessment any resident acquires any vested right to any amount representing capital of any trust which is not a resident, that amount must be included in the income of that resident in that year, if-*

- (a) that capital arose from any receipts and accruals of such trust which would have constituted income if such trust had been a resident, in any previous year of assessment during which that resident had a contingent right to that amount; and*
- (b) that amount has not been subject to tax in the Republic in terms of this Act.*

*(3) Any deduction or allowance which may be made under the provisions of this Act in the determination of the taxable income derived by way of any amount referred to in subsection (1), must, to the extent to which that amount is under that subsection deemed to be an amount which has accrued to-*

- (a) a beneficiary, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary; and*
- (b) the trust, be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that trust.*

*(4) The deduction or allowance contemplated in subsection (3) which is deemed to be made in the determination of the taxable income of a beneficiary of a trust during any year of assessment, shall be limited to so much of the amount deemed to have been received by or accrued to that beneficiary in terms of subsection (1), as is included in the income of that beneficiary during that year of assessment*



*(5) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the amount included in the income of the beneficiary during a year of assessment as contemplated in that subsection-*

*(a) is deemed to be a deduction or allowance which may be made in the determination of the taxable income of the trust during that year: Provided that the sum of those deductions and allowances shall be limited to the taxable income of that trust during that year of assessment as calculated before allowing any deduction or allowance under this subsection; or*

*(b) where the trust is not subject to tax in the Republic, must be carried forward and be deemed to be a deduction or allowance which may be made in the determination of the taxable income derived by that beneficiary by way of amounts referred to in subsection (1) during the immediately succeeding year of assessment.*

*(6) The amount by which the sum of the deductions and allowances contemplated in subsection (4) exceeds the sum of the amount included in the income of the beneficiary as contemplated in subsection (4) and the taxable income of the trust as contemplated in subsection (5)(a), must be deemed to be a deduction or allowance for purposes of subsection (3), which may be made in the determination of the taxable income derived by that beneficiary by way of any amount referred to in subsection (1) during the immediately succeeding year of assessment.*

*(7) Subsections (4), (5) and (6) do not apply in respect of any amount which is deemed to have accrued to any beneficiary in terms of subsection (1), where that beneficiary is not subject to tax in the Republic on that amount.*

### **Section 31**

*(1) For the purposes of this section –*



**'affected transaction'** means any transaction, operation, scheme, agreement or understanding where –

(a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both-

(i) (aa) a person that is a resident; and

(bb) any other person that is not a resident;

(ii) (aa) a person that is not a resident; and

(bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;

(iii) (aa) a person that is a resident; and

(bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or

(iv) (aa) a person that is not a resident; and

(bb) any other person that is a controlled foreign company in relation to any resident,

and those persons are connected persons in relation to one another; and

(b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length.



## Trust Property Control Act, 57 of 1988

“Trusts” are defined in the TPCA as:

*The arrangement through which the ownership in property of one person is by virtue of a trust instrument made over or bequeathed:*

- (c) to another person, the trustee, in whole or in part, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument; or*
- (d) to the beneficiaries designated in the trust instrument, which property is placed under the control of another person, the trustee, to be administered or disposed of according to the provisions of the trust instrument for the benefit of the person or class of persons designated in the trust instrument or for the achievement of the object stated in the trust instrument, but does not include the case where the property of another person is to be administered by any person as executor, tutor or curator in terms of the provisions of the Administration of Estates Act, 1965.*