Earl Group

South African Tax Provisions Relevant to Offshore Trusts – high level overview

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1 DONATIONS TAX

1.1 Under section 54 of the Income Tax Act No. 58 of 1962 ("**the Act**"), South African tax residents who donate property are subject to donations tax on the value of the property donated at a rate of:

1.1.1 20% if the aggregate of all donations made after 1 March 2018 that are subject to donations tax is less than or equal to R30 million;

1.1.2 25% on all donations once the aggregate of all donations made after 1 March 2018 that are subject to donations tax exceeds R30 million.

1.2 Settlements made on trusts, if not loaned to the trust, will be subject to donations tax.

1.3 The forgiveness of a loan to a Trust is also subject to donations tax at the time that it is forgiven.

1.4 There are various donations tax exemptions that have applied over the years, and could possibly apply to a client's position. The most common ones are:

1.4.1 Funds received as a donation from a non-resident and then onward donated are exempt from donations tax (provided certain requirements are met);

1.4.2 Funds inherited from a non-resident and donated are exempt from donations tax.

1.5 The first R100 000 per annum is exempt from donations tax.

1.6 Any such loan will be included in the resident's estate for estate duty purposes (the rates are the same as in 1.1.1 and 1.1.2 above).

2 LOANS TO OFFSHORE TRUSTS

2.1 If a loan, advance or credit is provided to a trust (or a company held by a trust), and the interest that is charged on that loan is less than the amount that would have been charged at the "official rate of interest", the difference between the interest actually charged (if any) and the "official rate of interest" is deemed to be a donation made by the lender (in terms of section 7C of the Act).

2.2 The "official rate of interest" is defined as the South African repurchase rate plus 100 basis points for loans denominated in ZAR, and the currency equivalent of the repurchase rate plus 100 basis points for loans denominated in any other currency.

2.3 The deemed donation occurs at the end of the year of assessment (last day of February) and is subject to donations tax at the rates set out in 1.1 above.

2.4 The charging of interest will avoid the application of section 7C and section 7(8) (see 3 below), but the result of that would be income tax being payable on the interest received at a maximum rate of 45%.

3 TAX ATTRIBUTION RULES – TAXATION OF THE DONOR

3.1 The South African tax rules apply to tax the donor of a trust first. If an amount is not taxable in the hands of the donor because the relevant rules do not apply, the amount may then be taxed in the hands of the beneficiaries of the trust when they receive a distribution. The same amount will not be taxed in the hands of the donor and again in the hands of the beneficiaries.

3.2 Section 7(8) of the Act contains what is referred to as the "tax attribution rules" which state that a resident will be taxed on income received by or accrued to an offshore trust if:

3.2.1 the resident made a "donation, settlement or other disposition" to that offshore trust;

3.2.2 the trust's (or its subsidiary's) income was attributable to that donation, settlement or other disposition; and

3.2.3 the income would have been subject to tax in South Africa if that trust had been a resident.

3.3 Similarly, in terms of paragraph 72 of the Eighth Schedule to the Act, a capital profit derived by a non-resident trust can be taxed in the hands of a resident donor as CGT if:

3.3.1 the resident made a "donation, settlement or other disposition"; and

3.3.2 a capital gain (or an amount that would have constituted a capital gain if the trust was a resident) arose which was attributable to that donation, settlement or other disposition and vested in a non-resident.

3.4 This rule was first introduced in section 9D of the Act on 1 July 1997 and was later moved to section 7(8) where is currently resides. Nevertheless, it applies to all donations made to a trust from 1 July 1997.

3.5 Effectively, the tax attribution rules result in the Settlor or subsequent donor being taxed in his or her hands on all income and capital gains made by the trust (or its subsidiary) that can be attributed to the donations. These rules require one to hypothesize that the trust was a South African tax resident trust for the years in question and determine if, as a resident, the trust would have been liable to pay tax on the income and gains generated, bearing in mind the type of income and the various exemptions available.

3.6 The application of the tax attribution rules cease if the donor to whom the income is being attributed ceases to be South African tax resident or dies.

3.7 In order for the attribution rules to apply, the donor must have been a South African tax resident at the time of the donation. If a person makes a donation to a trust before

becoming a South African tax resident, the attribution rules will not apply to him, even when he becomes a resident.

3.8 The attribution rules only need to be considered if the trust is funded by way of a donation or a partial donation. If the trust is funded entirely by donations from South African residents then all the income and gains in the trust will be attributable to the resident donors. If, however, the trust is funded by way of a low-interest or an interest-free loan, the interest that the trust would have paid if it had received a loan from a third-party is considered to be a donation for purposes of the tax attribution rules.

3.9 Example: interest-free loan

3.9.1 Assume that the loan amounts to R10 million and an appropriate interest rate for the purpose of the attribution rules is 10%.

3.9.2 In the first year income and capital gains of R1 million would have to be attributed to the lender. If the amount of income is only, say, R100 000, then that income will be attributed and the balance of R900 000 will be carried forward.

3.9.3 Thus the next year's attribution will comprise that year's R1 million plus the R900 000 brought forward, totalling R1.9 million.

3.9.4 Consequently, if in year two the income and capital gains to be attributed amount to, say, R1.8 million, then the full amount will be attributed and an amount of R100 000 will be carried forward to the following year. If, however, in year two the trust earns income of R2 million, only R1.9 million will be attributed to the lender and the remaining R100 000 will escape attribution (it is not carried forward).

3.10 The "official rate of interest" is only stipulated as the acceptable rate of interest for purposes of determining the deemed donation under section 7C and not for purposes of determining an acceptable rate of interest for purposes of the tax attribution rules. There is no prescribed or safe-harbour rate of interest for purposes of the tax attribution rules and SARS states that the acceptable rate is the rate at which the trust could borrow from a third-party.

4 TAX DISTRIBUTION RULES – TAXATION OF BENEFICIARIES

4.1 If amounts are not taxed under the above tax attribution rules, they may be taxed upon distribution to beneficiaries, depending on the nature of the amounts distributed.

4.2 Distributions of original trust capital (ie the original settlements on the trust) are tax-free.

4.3 If an amount (whether income or capital profit) is received by a trust and distributed to a beneficiary in the same year of assessment, the amount is deemed to have been received directly by the beneficiary, and not by the trust and is taxed as such in the hands of the beneficiary (section 25B(1) of the Act and paragraph 80(2) of the Eighth Schedule to the Act). Accordingly, dividends will be taxed at 20% in the hands of the beneficiary (regardless of the shareholding of the trust in the underlying company), interest will be taxed at the maximum rate of 45% and capital gains at a maximum of 18%.

4.4 Where a trust vests an asset in a resident beneficiary, the trust is deemed to have disposed of the asset at market value under paragraph 38 of the Eighth Schedule,

because the trust and the beneficiary are connected persons in relation to each other. The trust must disregard any capital gain derived from the disposal of that asset and the beneficiary is taxed on that capital gain under paragraph 80(1).

4.5 Section 25B(2A) of the Act provides that where a resident beneficiary acquires a vested right to capital of a non-resident trust, that amount must be taxed as income in the hands of the resident beneficiary if:

4.5.1 that capital arose from receipts or accruals of that trust in a previous year of assessment;

4.5.2 those amounts would have been taxed in the hands of the trust if the trust had been a resident;

4.5.3 those amounts had not been taxed in South Africa; and

4.5.4 the beneficiary had a contingent right to those amounts in that previous year of assessment.

4.6 Paragraph 80(3) of the Eighth Schedule to the Act is the corresponding capital gains tax provision and stipulates that where a resident beneficiary acquires a vested right to the capital of a non-resident trust, that amount must be taxed as a capital gain in the hands of the resident beneficiary if:

4.6.1 the capital consists of or is derived from a capital gain of the trust or an amount that would have been a capital gain of the trust if it had been a resident;

4.6.2 the capital gain arose in a previous year of assessment;

4.6.3 the capital gain was not taxed in South Africa; and

4.6.4 the resident beneficiary had a contingent right to that capital gain in that previous year of assessment.

4.7 There are particular provisions that apply to the taxation of capitalised dividends when distributed to South African residents:

4.7.1 If the trust held 10% or more of the equity shares and voting rights in the company declaring the dividends, but 50% or less, the capitalised dividends will be exempt from tax when distributed to a South African resident beneficiary. The other 50% of the shares in the company cannot be held by a connected person in relation to the trust (eg another trust with common beneficiaries, or the beneficiaries directly).

4.7.2 If the trust holds less than 10% of the equity shares and voting rights in the company, the capitalised dividends will be taxed at 20% when distributed to resident beneficiaries.

4.7.3 If the trust holds more than 50% of the equity shares and voting rights in the company (either alone or with a connected person), the capitalised dividends will be taxed at 20% when distributed to beneficiaries.

4.8 Similarly, if the trust realises a capital profit from the disposal of shares to a non-resident, unconnected person, which shares were held for at least 18 months, and the capital profit is awarded to a South African resident beneficiary in subsequent year of assessment, the following applies:

4.8.1 **If the trust held less than 10% of the equity shares and voting rights in the company, the capital gain awarded to the beneficiary will be subject to tax in the beneficiary's hands his or her effective CGT rate (maximum effective rate of 18%).**

4.8.2 **If the trust held 10% or more of the equity shares and voting rights in the company, but 50% or less, the capital gain awarded will not be subject to tax in the beneficiary's hands. The other 50% of the shares in the company cannot be held by a connected person in relation to the trust.**

4.8.3 **If the trust held more than 50% of the equity shares and voting rights in the company, the capital gain awarded will be taxed in the beneficiary's hands at his or her effective CGT rate.**

4.9 **There are no LIFO or FIFO rules which apply. This means that the trustees are free to select non-taxable funds for distribution. Similarly, the trustees are free to select low-tax funds for distribution, like capital gains, before or instead of selecting high-tax funds for distribution, like interest. Likewise they can use cash flows generated by, say, interest or dividends to pay tax-free settled capital. The trustees are required to keep appropriate records of the origin and nature of the trust funds for this purpose.**

4.10 **It is reiterated that distributions out of capitalized income or gains where that income or those gains had been subject to the attribution rules, will not be taxable in the beneficiary's hands.**