Nexia SAB&T
Training and Technical

Interest-free loans to Trusts

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The 2016 draft Taxation Laws Amendment Bill introduced a new section - Section 7C - to the Income Tax Act which provides detail and measures to prevent Estate Duty and Donations Tax avoidance through the transfer of assets to a Trust on interest-free loan accounts.

Current situation

When transferring assets to a Trust, a person has the following three options:

1. A person can donate the assets to the Trust and trigger Donations Tax at 20% of the fair market value of the assets in the hands of the person. The attribution rules contained in sections 7(3) to 7(8) may also apply to any income earned by the Trust as a consequence of the donation and have the effect of taxing such income in the hands of the donor;
2. A person can sell the assets to the Trust on loan account at an arm's length interest rate. The transferor will be taxed on the interest received from the Trust and there could be scope for the Trust to deduct the interest expenditure to the extent that is incurred in the production of income; or
3. A person can sell the assets to the Trust on loan account at an interest rate below that considered to be an arm's length rate. Traditionally, such loans have been interest-free.

The new section 7C is designed to prevent the avoidance of tax which arises under option 3 outlined above. The section applies in respect of the following:

- A person made a loan or advance to a trust
- No interest is incurred by the trust for the loan/advance
- The person giving the loan/advance is a connected person to the trust

The following is also included in this scope:

- The loan is made by any company which the founder is connected; and
- Interest is charged but at a rate less than the official rate of interest as contemplated in the Seventh Schedule to the Income Tax Act, No 58 of 1962 (Act).

The above is explained as follows:

- A person is connected to the trust if the person or any relative is a beneficiary of the trust.
- A company is connected if any person individually or jointly with another connected person holds directly or indirectly at least 20% of the company's equity share capital or voting rights.

What are the implications of s7c?

- Interest will be deemed to be charged at the official rate;
- The interest due will be imputed to the lender. In other words, the interest will be added to the lender's taxable income, for assessment;
- The lender will not be able to deduct such deemed interest from his interest income by availing himself of the interest free exemption set out in s10(1) (i) of the Act;
- If the lender fails to reclaim the additional tax payable from the trust within three years, the said amount will be treated as having been donated by the person to the trust; and
- The lender will not be able to reduce the loan (either the original or the subsequent loan), by utilising the donation exemption set out in s56(2) of the Act, yearly or at all.

Exemptions

Certain loans to trusts are specifically excluded and, therefore, the proposed section would not apply. These are:

- Loans to Public Benefit Organisations
- Loans provided in return for a vested interest in the income and assets of the trust - further conditions for this exemption to apply. It should also be noted that if a person obtains a vested interest in the income and assets of a trust, then these will translate to assets and deemed assets in the individual's estate for estate duty purposes. In a number of the cases, the aforesaid will negate some or all of the (estate duty) benefits of the trust
- Loans to special trusts, but limited to special trusts that were created for disabled persons
- Where the trust used the loan capital to acquire a property that is used by the creditor or his/her spouse as their primary residence (as defined)
- If the transfer pricing provisions of section 31 applies to the loan. This provision, therefore, applies to loans to offshore trusts. (There was uncertainty under the previous draft about the interaction between the application between sections 7C and 31, which has now be clarified)
- Loans to trusts that are subject to Sharia-compliant financing arrangements
- Loans that are subject to section 64E(4). In other words, loans that are subject to the deemed dividend provisions would not be taxed under this section.

Effective date:
The new requirement is effective from 1 March 2017 and applies in respect of any amount owed by a trust in respect of a loan, advance or credit provided to that trust before, on or after that date.