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BULLETIN

Davis Tax Committee on Estate Duty

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Executive Summary

The release of the Davis Tax Committee (DTC) Report on Estate Duty on the 13th of July 2015 for public comment has created much consternation in the Financial Services industry in South Africa. In particular the impact these proposals may have on traditional methods of effective Estate and Succession planning vehicles such as Trust structures.

The report specifically identifies Estate Duty as a crucial form of taxation and the role it can play in the redistribution of wealth, given the long history of extreme inequality in South Africa. Whilst Estate Duty only affects a small portion of South Africa's population it is clearly a form of Wealth Tax.

The report acknowledges that Estate Duty is favoured to other Wealth Taxes such as Capital Transfer Tax or a Direct Wealth Tax, which were both proposals under the Katz Commission and considered by the DTC. The complexities of implementing and administering such taxes are seen to simply outweigh the benefits and hence the preference for the continuity and enhancement of the Estate Duty system of taxation.

The DTC have identified that increasing revenues from Estate Duty will play a key role in addressing South Africa's debt levels and make additional funds available for public spending, which will allow Government to address some of the inefficiencies in our economy.

Estate Duty Revenues represent a fraction of the overall tax providing only a little over R1 billion to SARS's coffers. The objective is to increase this beyond the R15 billion level making it a far more meaningful contributor to Government resources.

To achieve such an increase requires a paradigm shift in existing legislation. The DTC are recommending various far reaching changes which focus on arrangements that keep assets out of a person's dutiable estate on death. These include Inter Vivos Trusts, Discretionary Trusts and over-funded Retirement Annuities. The report brands these three as the main 'culprits'. The recommendations would make trust arrangements commercially unattractive to discourage people from using them to avoid estate duty and reduce the benefit of retirement annuities.

The End of Trusts?

The DTC accept that people must be allowed to make use of trusts where there are sound commercial reasons for doing so, but states that people must then also accept any adverse tax consequences for doing so.

The DTC also acknowledge that the General Anti Avoidance Rules (GAAR) are often difficult to enforce as many of these arrangements have been established for sound financial planning and not tax reasons. SARS' ability to attack a structure is only possible where the arrangement is a simulated transaction and the primary intention is clearly tax avoidance. This means that each case would need to be assessed independently, making it almost impossible for SARS to create a legal precedent on any form of structure.

Domestic Trusts

The committee therefore propose that for Domestic or Inter Vivos Trusts that the attribution/conduit principle contained in Section 25B of the Income Tax Act be removed. Currently, this allows all income distributed to a beneficiary in the year it arises to be taxed at the beneficiary's personal tax rates (18%-41%). The equivalent also holds true for CGT where the effective rate paid can be anything between 6% - 13.65%. Both are subject to the various anti-avoidance provisions, which could deem the income or gains to be that of the settlor if any form of gratuitous disposition has taken place.

With the attribution or conduit principle removed it will mean all income is taxed at trust level at a flat 40%, and similarly gains will be taxed at an effective 26.6%. This will certainly make the use of Inter Vivos and Discretionary Trusts far less attractive.

Offshore Trusts

With regard to Offshore Trusts, the options available to the authorities are more limited because SARS cannot tax a non-resident entity as its reach only extends to the SA tax resident settlor and beneficiary.

This allows offshore trusts established in tax neutral jurisdictions to benefit from tax exempt growth and thereby tax is deferred until a distribution is made to a SA resident beneficiary, subject however to Section 7(8) anti-avoidance regulations.

The difficulty with this is determining whether these distributions are income or capital, which is why the DTC recommends that any distribution from an offshore trust should be treated as income in the beneficiary's hands.

Therefore under the recommendations, beneficiaries of an offshore trust will continue to have more flexibility in determining when they receive distributions. Beneficiaries could base the timing of distributions on factors like their overall income tax liability and opt to take such distributions at a time when their taxable income is lower.

The Impact on OPES

How does this effect International Retirement Annuity Trusts like OPES?

First of all, OPES is an offshore retirement arrangement not governed by legislation that affects South African Retirement Funds. The DTC's proposals to ensure all contributions in excess of the tax-relievable contribution form part of a person's dutiable estate on death, do not apply. Not being a SA pension is why OPES contributions do not receive tax relief and all contributions are in effect post tax.

Secondly, the mechanism that provides OPES with its Estate Planning Benefit is the fact that it is underpinned by a trust structure whereby the member gives up ownership of their assets in expectation of drawing benefits in their retirement. Therefore the mitigation of Estate Duty isn't a function of any specific legislation (SA tax exemption) that applies to retirement funds, but is a function of it's form and the DTC acknowledges they cannot stop the Estate Planning benefits in relation to trust based structures.

OPES is different from a discretionary trust as there is a clear commercial purpose for using it, i.e. international retirement planning. OPES allows a person to diversify their pension assets outside of the borders of SA and ZAR based assets - with some of the motivations that underpin that being concerns about the economy, political uncertainty, and currency depreciation.

OPES is in effect a special purpose trust that was established for the purpose of providing its members with benefits in retirement. This means it was not established or created by the member, as is the case with a Discretionary Trust, but involves the member joining an existing arrangement, which is much like any domestic multi-member pension plan.

There is no donation or element of gratuitous disposition when contributing to a retirement or pension arrangement as there is a clear quid pro quo. The member makes a contribution in return for being able to request a benefit in their retirement from their foreign plan.

Typical Client Scenario

If the DTC recommendations are approved and all distributions from any kind of offshore trust structure (including retirement plans) are taxed at 40%, then for people planning on making regular withdrawals, it becomes less attractive. For a typical client offshore structures still retain many significant benefits.

So imagine a typical client, age 60, who invests R10 million/£500K into OPES (international retirement plan), which at moderate growth rates has grown to the equivalent of R16 million/£800K after 8 years. Over the next 10 years he makes various withdrawals totalling R4 million/£200K at which point he dies and his remaining fund value is R20 million/£1 million. (For illustrative purposes we have assumed an exchange rate of 20:1)

Assuming the DTC proposals are legislated and the client has his distributions taxed at 40% - he would have paid R1.6 million in income tax on those withdrawals. That's an effective rate of 8% against the value of his OPES when he dies, certainly not prohibitive.

Meanwhile he still enjoys:

- Specific international provision for retirement
- Full Asset Protection due to ownership of assets transferring to the OPES
- Tax free roll up on growth in the plan
- Internationally diversified retirement portfolio to protect against economic and political uncertainty which could impact SA based pension assets given Regulation 28 and exchange control
- A true Rand hedge to protect assets against Rand weakness or volatility
- Estate Duty Savings of R4 million
- Avoids foreign probate and cross border tax complication of holding foreign assets direct
- Mitigates the need for foreign wills, potential for foreign tax returns and need for foreign executors representing significant time and cost savings
- Seamless Succession and passing on of wealth to nominated beneficiaries in an efficient manner in terms of cost, tax and time
- Total peace of mind for him and his family as OPES provides an economic safe haven irrespective of future outcomes in South Africa which may include emigration

Conclusion

Much needs to happen before any of the DTC recommendations become law. A lot of what has been recommended isn't new, having been suggested by the Katz commission more than a decade ago and which were rejected given the risks they posed to the greater financial stability of the country.

There will no doubt be intense lobbying from industry so which of these proposals are adopted and in what form will only become clear in time. However, it is clear that South Africa needs to generate additional tax revenues and change will come.

The DTC acknowledges it can't stop people from utilizing trust structures, and one of the key benefits of making use of such a vehicle remains estate planning. That is, unless it can be proved it was a simulated transaction where the only intention was tax avoidance, which is not the case of an international retirement plan (OPES).

Assuming the worst and these proposals are enforced it will certainly make domestic trust structures very unattractive for individuals. However, there is a clear commercial purpose for a person to make use of OPES. The benefits persist and extend far beyond taxation, providing peace of mind, financial security and certainty for South Africans and their families in what is an uncertain world.

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