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BULLETIN

Davis Tax Committee – Final Update

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The Davis Tax Committee (DTC) published its closing report on the 12th April 2018 following its formation on the 17th July 2013. Over this period the committee issued a total of 25 reports to the Minister of Finance with many wide-reaching recommendations in respect of taxation. The Committee's first and final paper on Estate Duty, which covered Retirement Funds, Capital Gains, Trusts, Donations, Loans to Trusts, Foreign Retirement Plans and Anti Avoidance are the most relevant to clients using international arrangements such as foreign trusts and retirement plans.

The Wealth Tax Paper published on the 18 March 2018 should be read in conjunction with the two Estate Duty papers as together they provide a greater insight into the mindset of the DTC. Given the socioeconomic issues facing South Africa it indicates a probable future for tax in South Africa which is a general hardening of policy in respect of wealth.

This bulletin does not aim to provide a comprehensive review of these papers or their recommendations, but "cherry picks" certain outcomes that have resulted from them. It also briefly comments on the DTC's paper on Wealth Tax and certain potential implications for the future.

Estate Duty Key Outcomes

Retirement Funds

- The practice of making retirement provision to tax approved retirement vehicles, in excess of the tax relieved limits, to benefit from the Estate Duty exemptions was addressed in 2016. Contributions were capped at ZAR350K per annum or 27.6% of earning, whichever the lower.
- The Estate Duty Act saw an amendment in the form of Section 3(2) bA which placed all non-tax relieved contributions back into the members estate.

For clients this meant a reduction in the income tax relief available and, in addition, a reduction in terms of estate duty relief.

Loans, Advances or Credit to Trusts (Domestic and Foreign)

- 2017 saw a new section, Section 7C, introduced to the Income Tax Act which applies to any loan, advance or credit to a trust, by a natural person or a company with a connected person relationship that does not charge interest, or charges interest at a lower rate than the official lending rate.
- The difference between the official rate of interest and the rate of interest charged is deemed a donation and donations tax of 20% will be payable thereon, by the person who granted the loan unless the commercial terms of the loan has been normalised.

For clients this increases the actual cost of running a trust as it creates an additional financial obligation to fund the tax owed on the interest receivable, irrespective of whether interest it actually paid to the settlor or not. Failure to take on this income tax burden results in the loan amount being taxed as a donation at 20% (subject to the exemption of R100K).

As such, the loan capital would fall foul of Section 7 (8) and all gains and income from the loan capital invested in the trust would be deemed as income in the hands of the settlor and taxed on an arising basis irrespective of whether the trust distributes the income or not. Under such circumstances the roll up environment for offshore trusts is defeated.

So, whilst a loan to a trust, on commercial terms, will continue to mitigate a one off donations tax charge on the loan capital, this benefit will be eroded over time due to the income tax on the loan interest and reduces the tax efficiency of trusts over the long term.

Foreign Trusts

- The DTC concluded that foreign trusts or trust-based arrangements, could not be taxed as they fell outside of the judicial purview of SARS as they are non-resident in terms of the Income Tax Act, hence Section 25(b)(2A) of the Income Tax Act must be retained so that any distribution of income to a South African tax resident can be taxed.
- The importance of this must not be overlooked as it preserves the roll up environment for foreign trust based arrangements, provided: they don't become tax resident in South Africa, have named or vested beneficiaries who are South African tax residents, are subject to the deeming provisions of Section 7(8) in respect of donations or are subject to the Amnesty Act.

For client this means that properly structured and administered trust based arrangement continue to offer a gross roll up environment.

Estate Duty

- Estate duty has seen its first increase since South Africa changed to a Residency Based system of taxation in 2001, with estates over R30 million now subject to a 25% charge on assets in excess of this limit, up from 20%.
- The DTC also recommended that all South African residents should be required to fully disclose their assets from 2020 onwards where their net wealth exceeds R30 million to record wealth, the nature of wealth and provide a body of facts which can be used when considering how a net worth (wealth) tax could be developed and applied.

For most of the population these points are of little significance but the intent in terms of wealth distribution is clear. This is further evident when considered with the amendment to the Estate Duty Act in respect of non-tax relieved contributions to domestic South African Pension Funds, Provident Funds and Retirement Annuities, as defined in the Income Tax Act. Such non-tax relieved funds now form part of your estate and hence the concept of wealth tax is present in traditional safe havens further down the wealth spectrum. Other recommendations by the DTC include the removal of both tax-free gifting between spouses and the ability for spouses to leave their estate to one another on death free of estate duty (subject to a proposed new abatement per individual). Whether these recommendations or the requirement to fully disclose all assets are taken up is not known at this time.

Foreign Retirement Plans

- International Pensions were addressed in the 2nd paper on Estate Duty in early 2016, but no recommendations were specifically made with regards to them. Albeit, it was recommended that SARS undertake a review of foreign pensions.
- SARS reissued General Binding Ruling 25 (Issue 2) on the 16th March 2016, to confirm the tax treatment of foreign pensions.
- The DTC issued a broader statement as a reminder that if the intent of any arrangement (trust, corporate structure, contract or other) is to conceal its true purpose then SARS possesses anti avoidance powers to address such mischief and that these powers are further supported by legal precedent in South Africa's courts, in particular the precedent set by the case SARS v NWK Ltd 2011 (2) SA 67 (SCA).

For clients the implication of the above two points are i) income from foreign pensions is taxable unless the pension was funded by an employer for services rendered overseas and ii) there is no reason why an individual cannot make use of a foreign pension provided it is used for the purpose for which it's intended i.e. to provide in retirement.

Wealth Tax

The paper on wealth tax was not part of the initial brief given to the DTC but was motivated by the ANC in 2016 following their annual jamboree. Whilst the DTC's position is very clear i.e. South Africa needs to distribute wealth given the inequity of wealth ownership in South Africa it did point out that many questions remained unanswered around how such a mechanism may function – even though we saw estate duty raise to 25% for estates over R30 million this year.

The Committee raised the point of whether Retirement Funds should form part of ones 'wealth' from a net wealth tax perspective. The argument they put forward was balanced and the DTC clearly identified with the need for individuals to make provision for life after employment and the impact of increasing longevity. Hence the need for incentives to save for retirement. Trade unions in South Africa, that contributed to the consultation, were opposed to retirement funds forming part of one's net wealth as this would have a far-reaching effect on the blue collar and middle classes whose major source of accumulated wealth is typically their retirement funds, albeit the actual values would in reality be limited due to their earnings. The counter argument was to reduce some of the benefits pension funds currently enjoy such as: no CGT, exemption of tax on dividends and possibly further restrict tax relief on contributions. That said the paper identified a significantly wide range of areas where a net worth tax could be applied. However, the point is that retirement plans will be fought over should a new wealth tax be implemented.

Conclusion

In the short term the DTC has clearly made its mark resulting in harder tax policy for individuals and corporations alike. On the personal side their recommendations have resulted in reductions in retirement relief, widening the application and rate of estate duty and reducing the tax efficiency of trusts be they domestic or foreign. These measures should have a positive impact for the fiscus and by virtue thereof the country, provided it is spent wisely and not subject to continued corruption and mismanagement by government which is the wide spread and well publicised public concern.

The DTC also set the long-term trajectory for tax policy which is focused on addressing the imbalance of wealth in South Africa and their view of a need to redistribute wealth to address poverty and the many social ills that stem from fiscal imbalance. The committee has built much of their view on the back of South African wealth statistics and demographics and the conclusions reached are supported by a range of academics who support socialist policy.

This again raises the philosophical debate for South Africa – is the country best served by socialist policies or capitalist ones? Err too far to the socialist agenda and risk losing the entrepreneurs that drive South African economic growth which in turn fills the receiver's tax coffers. Err too far to the capitalist model and risk compounding the wealth distribution issues and social implications.

Whatever the future holds and whatever the long-term socio-economic policies in South Africa are, one thing is clear, all South Africans will be required to carry the cost burden of the State and those with wealth will be required to carry far more than they do today.

This backdrop means that individuals need to consider how best to manage and arrange their wealth both now and in the future. All South Africans have the right to protect and arrange their affairs so that they can achieve financial independence for themselves and their families. However, achieving this objective will arguably become more difficult as time moves on.

If you have any questions, please email our Business Support Team Leader, Nicole Dijkstra, on nicole@overseaspension.com or call the South African office on +27 (0) 21 851 5584.

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