Assets and family outside SA, trusts and tax

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South African families who have created South African as well as foreign trusts may be living all over the world.

Similarly, foreigners who have foreign trusts may be living in South Africa. The use of foreign trusts has been the subject matter of legislative intervention over the years. South African exchange controls were relaxed a number of years ago, allowing South Africans to invest offshore, many in so-called tax haven countries that impose zero or low rates of tax on trusts.

Although it is useful for South African residents to have foreign trusts in which offshore assets are held, the largest drawback is the substantial cost involved in the registration and administration of those foreign trusts. Generally, the administration costs pertaining to foreign trusts are substantially higher than those of South African trusts, which has discouraged people from using these structures.

Many countries take a hostile view of foreign trusts and many civil law countries do not recognise the concept of a trust. Therefore, a beneficiary of a South African trust who is resident in another part of the world can end up in an unintended messy tax predicament.

If you have a trust and a beneficiary intends moving abroad for any significant length of time, or even permanently, it is important to enquire about that country's tax treatment of distributions to beneficiaries of a discretionary South African trust and seek the necessary advice before the beneficiary takes up residence outside South Africa.

When the residence-based tax system was introduced in South Africa in 2001, the legislature, mindful of the possibility of avoidance of tax on foreign income using foreign trusts, enacted provisions aimed specifically at preventing such avoidance. Similar provisions exist to combat tax-avoidance resulting from donations and funding transactions between connected persons, such as between South African resident natural persons and South African and foreign trusts.

The taxation of income earned by foreign trusts is mainly regulated by the provisions of Section 7(8) (attribution rule for income) and Section 25B (distributions of income to beneficiaries) of the Income Tax Act. The taxation of capital gains is covered by Paragraphs 72 (attribution rule for capital gains) and 80 (distributions of capital gains to beneficiaries) of the Eighth Schedule to the Income Tax Act. Section 7(8) and Paragraphs 72, therefore, deals with amounts received by or accrued to non-residents as a result of a gratuitous disposition by a resident.

Similar to South African trusts, the soft loan funder can never be taxed on more than the amount equal to the interest not charged or forfeited on the loan with a below-market interest rate.

With effect from 1 March 2019, significant changes were made to the Income Tax Act relating to the taxation of income and capital gains earned by foreign trusts, foreign companies held by foreign trusts, distributions made to foreign beneficiaries and distributions made to South African resident beneficiaries from foreign trusts. These amendments were introduced to avoid the use of a foreign trust as a shield from tax in South Africa.

In addition to the above income and capital gains attribution rules, loans by South African resident natural persons to foreign trusts or to foreign companies held by foreign trusts with interest charged at below the official rate of interest (repo rate plus one percent) - or the foreign equivalent of the South African repo rate plus 100 basis points for the currency in which the loan was made - trigger the deemed donation rule in Section 7C of the Income Tax Act, provided that that South African resident natural person lender is a connected person in relation to that foreign trust.

The official rate of interest or equivalent interest rate for the currency in which the loan was made will be applied in the calculation. No actual interest adjustment is required. That South African resident natural person lender is deemed to make an ongoing annual donation equal to the minimum required interest not charged on the loan, which attracts annual Donations Tax.

In the unlikely event that the above attribution rules are not applied (through structuring of funding) - which results in tax avoidance by that South African resident natural person lender - then SARS will be able to apply the provisions of Section 31 of the Income Tax Act and deem that South African resident natural person lender to have charged a market-related interest rate on the loan and tax them accordingly.

In this instance, Section 7C would also not apply as it will cause double Donations Tax with Section 31 having its own deemed donation rule. There will therefore always be an Income and/or Capital Gains Tax and a Donations Tax implication for non-arm’s length lending transaction.

It is important to understand the tax treatment where South Africans participate in foreign structures, especially where foreign trusts are involved, as well as if family members live overseas.

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